

INVENTORY ACCOUNTING AND CAPITAL FORMATION

HEARING

BEFORE THE

SUBCOMMITTEE ON TAX, ACCESS TO EQUITY
CAPITAL AND BUSINESS OPPORTUNITIES

OF THE

COMMITTEE ON SMALL BUSINESS
HOUSE OF REPRESENTATIVES

NINETY-EIGHTH CONGRESS

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INVENTORY ACCOUNTING AND CAPITAL FORMATION

WEDNESDAY, OCTOBER 5, 1983

HOUSE OF REPRESENTATIVES,
SUBCOMMITTEE ON TAX, ACCESS TO EQUITY
CAPITAL AND BUSINESS OPPORTUNITIES,
COMMITTEE ON SMALL BUSINESS,
Washington, D.C.

The subcommittee met, pursuant to call, at 9:30 a.m., in room 2359-B, Rayburn House Office Building, Hon. Henry J. Nowak (chairman of the subcommittee) presiding.

OPENING STATEMENT OF CHAIRMAN NOWAK

Mr. NOWAK. The subcommittee will come to order and we will start our hearing. We have to take a break about 10:30. The President of Germany is speaking to the House and Senate and we will have to recess for that period of time, but we will continue right after. I welcome everyone here today and I will make a short opening statement after which we will start our first witness and see how far we go until we have to break. We will then come back and take the rest of the witnesses right through the lunch hour and hopefully, keep everybody on schedule.

Inventories can be the most important asset on the balance sheet of a small business. A variation in inventory pricing can have a direct and immediate impact on its taxable income. Nevertheless, smaller firms find it difficult to administer or to pay for the detailed recordkeeping needed to implement the preferred inventory method, the last-in, first-out [LIFO] method.

The need for inventory tax reform is no different than the need for accelerated depreciation reform. Through the enactment of the so-called Economic Recovery Tax Act of 1981, capital intensive firms benefited from the dramatic change in the tax treatment of depreciable assets as reflected by ACRS, the accelerated cost recovery system. The general rationale for ACRS was to provide for an increase in the cash flow of these capital intensive firms. Similarly, inventory reform is viewed as an important means of boosting the internal cash flow of small wholesalers and retailers.

In a recent article of Barron's National Business and Financial Weekly, Assistant Secretary of the Treasury for Tax Policy, John E. Chapoton, recognized the need for inventory tax simplification. He stated, "I just want to emphasize how important an issue this is because there's an awful lot of capital invested in this country in inventory."

Getting tax professionals to focus on inventory reform has not been an easy task. It was this subcommittee that conducted the first hearings ever held on the issue. Based on those hearings and others, I testified before the Ways and Means Committee during the 1981 tax debate. As part of my comprehensive capital formation package for small business, I urged the tax writing committees to adopt across-the-board simplification of inventory accounting methods.

ERTA did ultimately include a small measure of inventory tax reform. However, there is more to be done. Our inventory intensive businesses must be provided with true tax equity and reform. We cannot continue to have only 2.5 percent of all wholesalers and 1.5 percent of all retailers using the preferred LIFO method, as suggested by 1978 IRS statistics on corporations. Moreover, we must give serious consideration to adoption of such other proposals as the cash method of accounting and the implementation of an objective standard for the treatment of excess or obsolete inventory.

We would like at this point to call our first witness, the organization of American Institute of Certified Public Accountants. Mr. C. Paul Jannis is the chairman of the tax accounting subcommittee, Federal tax division of AICPA; presently he is teaching at the University of Miami in Florida. He is a retired partner of the Pittsburgh, Pa. branch of Price Waterhouse. He was the chief accounting method person for the firm nationwide.

We want to welcome you here today. I believe you are accompanied by Lawrence Portnoy, who is a partner, Price Waterhouse in Detroit, Mich.

Mr. JANNIS. Thank you, Mr. Chairman.

Mr. NOWAK. I might just add that your full text will be printed in the record and you can proceed from that.

TESTIMONY OF C. PAUL JANNIS, CHAIRMAN, TAX ACCOUNTING SUBCOMMITTEE, FEDERAL TAX DIVISION, AMERICAN INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS, ACCOMPANIED BY LAWRENCE PORTNOY, PARTNER, MEMBER, TASK FORCE ON INVENTORY PROBLEMS, FEDERAL TAX DIVISION, AICPA

Mr. JANNIS. Thank you very much.

As you mentioned, Mr. Chairman, for the last 2 years I have been chairman of the task force on inventory problems of the American Institute of Certified Public Accountants' Federal tax division, and we are very interested in the subject matter that is covered in your proposed bill.

I have attached to the statement a copy of certain recommendations that have been made by AICPA in the past which cover some of the subsections in your bill. These are taken from an American Institute publication called *Recommended Tax Law Changes*. There are attached pages and you will see that I will summarize first the items on which the American Institute has already taken a position, which I think for the most part are consistent with your recommendations.

The first one deals with the suggested repeal of the LIFO conformity requirement. We agree wholeheartedly. We think the con-

formity requirement has outlived whatever useful purpose it initially served for tax policy.

Section 3 of the bill would permit 10-year averaging for any increases in inventory to cost when a taxpayer adopts the LIFO method. We agree completely with that recommendation. We think that the ERTA 3-year spread was an improvement but 10 years is more consistent with the period allowed by IRS generally on changes to accounting methods.

On section 7, limitations on recapture of LIFO benefits, our recommendation has been and continues to be that the sections which were added in 1980, which recapture the LIFO reserve the time of certain corporate liquidations, should be repealed. There is no logical reason to tax unrealized appreciation in inventory while unrealized appreciation in other assets is not similarly taxed.

On the write-down of excess inventory items, with a proposal to bring them down to fair market value over a 5-year period, we agree that there is a need for more objective standards to recognize the loss of utility in inventory, and we think perhaps that the 5-year period is appropriate. Our recommendation, however, would be to use taxpayer actual experience, looking back over 5 years, as is done with the Black Motor Co. formula in reserve for bad debts, although we have no objection to the 5-year usage formula as another acceptable alternative.

I would like to turn now to sections of the bill which have not been commented on heretofore by the AICPA and I would like to make just a brief statement before I give you the comments.

I accepted the request to appear at this hearing at a late date and have not had an opportunity to pass my statement on to members of the executive committee of the Federal tax division for prior review and approval. Therefore, I am giving you personal comments, although I have no reason at all to believe that they would not approve upon review.

Mr. NOWAK. Let me ask you a question.

When will that review take place? How long would you anticipate?

Mr. JANNIS. I think we could get it done within a matter of a couple of weeks.

Mr. NOWAK. We will keep the record open and when that is accomplished, we will incorporate that in the record also.

Mr. JANNIS. Your section 4 deals with simplification of inventory pooling, and I think it is a very, very definite step in the right direction.

First, it will increase from \$2 million to at least \$8 million the average annual gross receipts requirement which would allow the use of a single pooling.

I would also support the proposal which would permit a wholesaler-retailer who uses dollar value LIFO to establish pools either by use of the Government price index category or based on any groupings that are ordinarily customarily used in the industry.

Under present regulations a wholesaler-retailer must pool by major lines, types or classes of goods, and unfortunately, those terms are not defined. I think there is a need for clarification of these rules. I also see no reason why a large manufacturer or processor can use a single pool for the entire inventory investment of

an entire production line by using a natural business unit [NBU] pooling method whereas the wholesaler or retailer is denied that advantage.

Even though the regulations say that a wholesaler or retailer can use the NBU method, advance consent of the Commissioner of Internal Revenue is required to do so. In my experience permission is rarely granted.

Section 5 deals with the use of Government price indices. In the ERTA 1981 act, Congress directed Treasury to prescribe regulations which would permit the use of Government price indices for LIFO. Regulations were issued in March 1982. Unfortunately, I think they are not working. I saw no evidence of any widespread move to use the Government price indices for calendar 1982.

I would like to offer my opinion on why that is not happening.

I think the first reason is that the regulations limited taxpayers, other than qualified small business (defined as a taxpayer with less than \$2 million average annual gross receipts) to 80 percent rather than 100 percent of the price change computed using Government indices.

Another reason for nonuse is the requirement that a taxpayer use the most detailed index category found in either the CPI detailed report or the producer prices report.

For example, there are 113 detailed listings within the Food and Beverage CPI Report. If you turn to the commodity report for the producer prices on processed food, there are 178 detailed listings. Unfortunately, the descriptions of the listings in both reports do not coincide with the descriptions used in the books and accounts of most taxpayers.

For example, the typical retail grocery store has several thousand inventory items for which a most appropriate detailed index must be found. This is not easily done. Therefore, I think AICPA would support completely your recommendation that taxpayers be permitted to use the broader index grouping of 11 CPI or 15 PPI categories in lieu of the most detailed testing.

I most heartily endorse the proposal to liberalize use of the method of computing LIFO value under the link chain method. I think that the order of preference and the bias against link chain in the current regulations should be changed. The longer one uses LIFO, the more preferable the link chain method appears to be. It seems to me that, in today's highly changing technological environment, the link chain method may very well be a preferable method than the double extension method which the regulations seem to prefer.

Section 7 deals with limitations on the recapture of LIFO benefits. In the event the AICPA proposal to repeal is unacceptable, we would agree that some modification of the recapture calculation required under present law is appropriate.

It is our understanding that your bill intends to require recapture only of the excess of deductions claimed by a taxpayer under LIFO over what such deductions would have been if the taxpayer had used a published Government index.

Because we think that the language in the bill, as drafted, is difficult to interpret we have included in my written statement a recommended change which we offer for your consideration.

I won't take the time to go into that now if it is all right with you.

Section 8, the last section on which I will comment, would permit the use of the cash receipts and disbursements method by qualifying small businesses, listed in the bill as those with annual average gross receipts not in excess of \$2 million. I do not endorse that proposal. As a professional accountant I find that the cash method would be a departure from the well-established principle for both general accepted accounting principles and tax purposes which should not be undertaken by legislation. I think the accrual method is appropriate when inventories are used in a business.

In conclusion, Mr. Chairman, I would like to thank you on behalf of the institute. Larry Portnoy and I enjoyed being here. If you have any questions I am prepared to respond.

[Mr. Jannis' prepared statement with attachments follow:]

PREPARED STATEMENT OF C. PAUL JANNIS, CHAIRMAN, TAX ACCOUNTING SUBCOMMITTEE, FEDERAL TAX DIVISION, AMERICAN INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS

My name is C. Paul Jannis. I am appearing before you on behalf of the Federal Tax Division of the American Institute of Certified Public Accountants. For the last two years, I have been Chairman of the Division's Task Force on Inventory Problems, consisting of a group of practitioners very experienced in LIFO which has devoted considerable time to the study of the kinds of inventory problems encompassed by H.R. 3464. I am a recently retired partner of Price Waterhouse, where I headed up the Inventory Services Group, and am presently a member of the Accounting Faculty at the University of Miami in Coral Gables, Florida. I am accompanied today by Lawrence F. Portnoy, who is the present chairman of the Price Waterhouse Inventory Services Group, and is also a member of the AICPA Federal Tax Division's Task Force on Inventory Problems.

Certain of the provisions of the proposed "Inventory Simplification and Reform Tax Act of 1983" (H.R. 3464) are consistent with Legislative Recommendations previously made by the AICPA Federal Tax Division. I have attached to this Statement a copy of our Division's most recent legislative recommendations covering Sections 336, 337, 471, and 472 of the Internal Revenue Code. I would like first to summarize the particular AICPA recommendations which cover certain sections of H.R. 3464.

SEC. 2.—REPEAL OF REQUIREMENT THAT THE LIFO METHOD USED FOR TAX PURPOSES CONFORM TO THE ACCOUNTING METHOD USED FOR FINANCIAL PURPOSES

Although the income tax regulations (Section 1.472-2(e), as amended by T.D. 7756 on January 16, 1981), provided taxpayers with some much-needed relief from concern over disclosures of non-LIFO information which could cause the IRS to terminate a LIFO election, the rules remain somewhat restrictive and are believed to hinder LIFO adoptions by the smaller business community. Because the statute (subsections (c) and (e) of Section 472) requires conformity, the regulations require the use of only LIFO in the primary presentation of income, profit or loss for a taxable year in credit statements or financial reports.

The remaining vestings of the conformity requirement should be repealed, since they serve no useful purpose of tax policy. Repeal of the conformity requirement will simplify their preparation of financial statements, and free taxpayers and the IRS from devoting considerable time to rules which do not affect income tax liabilities. Repeal of the conformity requirement should help simplify LIFO adoptions by small business and help them in the preparation of financial statements needed for credit and management purposes.

SEC. 3.—10-YEAR AVERAGING PERMITTED FOR INCREASES IN INVENTORY VALUE REQUIRED FOR ADOPTION OF LIFO METHOD

The Economic Recovery Tax Act of 1981 permitted for the first time the ratable restoration to income over a 3-year period of any writedowns taken in computing inventory values at the close of the year preceding the first LIFO year. Such restoration to income is required because the statute requires opening inventory of the

first LIFO year to be stated at cost, thus necessitating a change from the method of valuing inventories at cost or market, whichever is lower, to the cost method.

Under Revenue Procedure 80-51, which provides the general rules for voluntary accounting method changes, the IRS usually allows a spread of up to ten years of an adjustment (whether positive or negative) caused by changes in tax accounting methods. The adjustment is generally taken into account ratably over the number of taxable years (not to exceed 10) the taxpayer has used the method of accounting that is being changed. In fact, taxpayers were permitted up to ten years to spread the adjustment required to restore excess inventory writedowns which were held to be unallowable deductions by the Supreme Court of the United States in the Thor Power Tool Company decision.

The initial tax cost of a LIFO adoption, caused by the statutorily required restorations of cost writedowns, should not be more burdensome to taxpayers than other accounting method changes. Lengthening the spread period from 3 to 10 years will make LIFO adoptions less costly to the small businessman.

SEC. 7.—LIMITATIONS ON RECAPTURE OF LIFO BENEFITS

We continue to believe that Sections 336(b) and 337(f), which provide for the taxation of LIFO recapture amounts where inventories are distributed in certain liquidations, should be repealed.

LIFO is a cost-flow concept which prices inventory on hand at year end as if it were acquired in prior taxable years to the extent that quantities do not exceed those of the prior years. Any excess viewed as having been acquired during the year.

Because of inflation, this inventory which is maintained on the books at cost (base cost in the year of LIFO adoption, and current cost in the year of acquisition of any layers) frequently contains unrealized appreciation which is taxed by Sections 336(b) and 337(f). We continue to believe that there is no logical reason to tax unrealized appreciation in inventory while the unrealized appreciation in other assets is not similarly taxed.

SEC. 9.—CERTAIN EXCESS INVENTORY ITEMS MAY BE WRITTEN DOWN TO FAIR MARKET VALUE OVER 5-YEAR PERIOD

In the Thor Power Tool Company decision (439 U.S. 522, 1979), the Supreme Court upheld the IRS interpretation of the Code to allow a deduction for the decline in value of excess inventories only in the taxable year in which the quantities are offered for sale at reduced prices or otherwise disposed of, as provided in the regulations. The *Thor* case contained a factual dispute (recognized by the Supreme Court) regarding the disposition of obsolete, damaged, or defective goods for which the IRS allowed deductions for writedowns. The IRS argued that such writedowns were allowed because *Thor* had scrapped such goods soon after writedown. *Thor* argued that 40 percent of the parts, for which the IRS had allowed writedown deductions, were still on hand, unscrapped three years later.

The regulations contain no guidelines of when goods are considered to be obsolete. As a practical matter, goods (parts in particular), frequently become excess inventories only because the underlying products for which they serve as components have become obsolete. The regulations regarding allowable reductions from cost for subnormal goods (section 1.471-2(c)) are ambiguous and contain what we believe to be an impractical requirement that such subnormal goods must be offered for sale within thirty days of the inventory date to establish a "market" value below cost. The law should recognize business realities and practicalities and provide for more certainty in this troublesome area in the interest of sound tax administration.

There is precedent in the law for allowing deductions on an estimated basis in valuation situations somewhat analogous to the determination of inventory values of goods which have lost utility. The use of the Black Motor Co. five-year averaging formula to determine allowable additions to the Reserve for Bad Debts, a valuation of accounts and notes receivable, is a good example of the recognition of business realities and practicalities.

We believe that the statute should be amended to provide taxpayers with a means of valuing excess inventories at not more than the net realizable value a taxpayer expects to receive for such goods. In determining such net realizable value, we believe that the taxpayer's facts and writedown experience over the preceding five years should be used in making the computation.

We believe that the five-year usage formula provided in H.R. 3464 is another acceptable alternative to the vexing matter of establishing allowable writedowns to market for excess inventory which has lost its utility to the taxpayer.

I will next discuss provisions in H.R. 3464 which have not been covered in the AICPA's publication of "Recommended Tax Law Changes."

The late date at which I accepted the request to appear at today's hearing prevented me from making my statement available in advance to members of the Executive Committee of the AICPA's Federal Tax Division for review and for obtaining such group's approval. I have no reason to believe, however, that such approval would not have been given. Nevertheless, the following observations regarding other subsections of H.R. 3464 are my personal views and not necessarily those of the Federal Tax Division.

SEC. 4.—SIMPLIFICATION OF INVENTORY POOLING REQUIREMENTS

In enacting section 474(b) of the Code in 1981, Congress recognized the need to simplify the dollar-value LIFO inventory pooling requirements in order to make a single pool available to the small businessman. We agree with the proposal in H.R. 3464 to increase the \$2,000,000 annual gross receipts requirement (averaged over three years in Section 474(b) to \$8,000,000. The proposed increase appropriately expands the base of small businesses which should use LIFO in appropriate conditions but choose not to because of cost of compliance with and the complexity of the income tax regulations.

We also support the proposal in H.R. 3464 to permit any taxpayer who is a wholesaler or retailer, and who uses dollar-value LIFO, to establish inventory pools either (1) according to applicable government price index categories, or (2) based on groupings that are ordinarily and customarily used in his industry.

Under the dollar-value LIFO regulations, a manufacturer or processor can include in a single pool all items which enter into the entire inventory investment for a natural business unit of a business enterprise. The regulations indicate that a natural business unit ordinarily consists of the entire productive activity of the enterprise within one product line or within two or more related product lines.

A wholesaler or retailer, on the other hand, is required by the regulations to place his items of inventory into pools by major lines, types or classes of goods. Although the regulations contemplate that wholesalers and retailers may appropriately use the natural business unit method of pooling, advance permission of the IRS is required to do so. In my experience, such permission is rarely granted.

There is uncertainty as to what is meant by "major lines, types or classes of goods" with the result that wholesalers and retailers adopting LIFO remain uncertain of the appropriateness of their LIFO pools until IRS examines and accepts the returns. There seems to be no compelling reason to permit a large manufacturer or processor to use a single LIFO pool, and deny a small wholesaler or retailer the same simple method of pooling with its attendant tax advantages. There is a definite tax advantage in being able to include all inventory items in a single pool rather than in multiple pools. The greater the number of pools, the greater the possibility of inventory liquidations in certain pools with a required repayment of LIFO tax benefits. When liquidations occur, lower cost inventory is reflected in cost of goods sold and taxable income is increased.

The ability to pool on the basis of either the 11 general expenditure categories of consumer goods described in the CPI Detailed Report or based on customary industry groupings, as proposed in H.R. 3464, should be welcomed by wholesalers and retailers. The proposal should simplify LIFO calculations, and assure more certainty as to the acceptability of pooling upon examination by the IRS.

SEC. 5.—USE OF GOVERNMENT PRICE INDICES PERMITTED IN CONNECTION WITH PRICING INVENTORIES UNDER LIFO METHOD

Section 472(f) was added to the Code by The Economic Recovery Tax Act of 1981. Under such subsection, the Treasury was directed to prescribe regulations permitting the use of suitable published government indices for LIFO computations. Regulations Section 1.472-8(e)(3), issued March 15, 1982 by T.D. 7814, is the presumed response. Such regulations allow the use of an external index for LIFO inventory to be computed with reference to BLS consumer or producer price indices. Although such indices could be used for taxable years beginning after December 31, 1981, there is little evidence of any widespread move to use such indices for calendar year 1982 by the small business community.

One of the reasons for nonuse may be the regulations' limitation to 80 percent of the computed price change for all taxpayers except eligible small businesses, as defined in Section 474(b) of the Code, who can use 100 percent. Another reason for nonuse may well be the requirement to assign to each inventory item, the most de-

tailed index category in either the "CPI Detailed Report" or in "Producer Prices and Price Indexes".

There are, for example, 113 detailed listings of consumer prices within the general category of "Food and Beverages" in the CPI Detailed Report. There are 178 detailed listings of prices underlying the two-digit "Processed Foods and Food" Code, one of the 15 general categories described in the "Producer Prices and Price Indexes" Report. For example, a typical retail grocery store might have several thousand inventory items for which the appropriate most detailed index category must be found. Finding the appropriate most detailed listing is not a simple matter, particularly when item descriptions of most taxpayers are not kept in accordance with the "group and item" or "commodity" classifications of the CPI and PPI reports.

Another reason for nonuse is the perceived and actual complexity of the regulations.

H.R. 3464 proposes the use of the published government price index for either: (1) any of the 11 general expenditure categories in the CPI Detailed Report; or (2) any of the 2-digit standard industrial classifications (15 in number) in the Producer Prices Data Report.

There is no question that dollar-value LIFO would be greatly simplified if such broad Government price indices were available to taxpayers generally, particularly when the published index would be available for an inventory grouping consistent with the pooling allowed in Section 4 of H.R. 3464.

Although there are wide variations in the underlying most detailed indices, we do not perceive particular benefits or detriments to either the government or taxpayers in permitting use of the broader index groupings as proposed in H.R. 3464.

SEC. 6.—METHOD OF COMPUTING LIFO VALUE OF DOLLAR-VALUE POOL MAY BE USED WITHOUT SHOWING OTHER METHODS ARE UNSUITABLE OR IMPRACTICAL

We endorse the proposal in H.R. 3464 that "any taxpayer may elect to use a link chain or index method of computing the LIFO value of any dollar-value pool without any showing that any other such method is unsuitable or impractical."

With the exception of certain qualifying department stores and others who may elect the CPI-PPI "80-100%" external BLS indices, the dollar-value LIFO regulations require the use of an internal index which must be determined by use of one of three methods, listed in the following order of presumed IRS preference: (1) double-extension, (2) index, and (3) link-chain.

The double extension method requires the quantity of each item in the inventory pool at the close of the year to be extended at both base-year (year of LIFO adoption) unit cost and at current-year unit cost. The index method (double-extension technique applied to a representative portion or statistical sample of the inventory) is permitted only "where the use of the double-extension method is impractical because of technological changes, the extensive variety of items, or extreme fluctuations in the variety of the items in a dollar-value pool." The use of the link-chain method is permitted under the regulations "only in those cases where the taxpayer can demonstrate to the satisfaction of the district director that the use of either an index method or double-extension method would be impractical or unsuitable in view of the nature of the pool."

The term "item" is not defined in either the regulations or other IRS pronouncements.

If a taxpayer enters a new item into a double-extension pool for the first time the regulations require the base-year unit cost of such new item entering a pool for the first time to be the current-year cost of that item unless the taxpayer is able to reconstruct or otherwise establish a different cost to the Commissioner's satisfaction. The term "new item" is also not defined in the regulations or other IRS pronouncements. The longer a taxpayer uses LIFO, the more difficult the task becomes of appropriately reconstructing base-year units cost of new items to the IRS' satisfaction.

Under the link-chain method, on the other hand, there is no need to reconstruct base-year unit cost for new items because closing inventory (either each item or a representative portion) is double-extended at beginning of the year (rather than base-year) and current-year unit costs. The current year's index is then multiplied by (or "linked" with) the preceding year's cumulative index to establish a cumulative index at the close of the current year relative to base LIFO. The link-chain method minimizes distortions which may be caused by improper reconstruction of base-year costs under either the double-extension or index methods.

Since 1976, taxpayer requests for permission to change to the link-chain method have been denied by the IRS unless the taxpayer demonstrates a 90 to 100 percent turnover (additions and deletions) of items within the pool during the five-year

period preceding the year of change. This arbitrary IRS position has created difficulty in situations where the link-chain method clearly appears preferable and avoids possible distortions of income. We see no tax policy reason to deny taxpayers the right to change to and to use the link-chain indexing method, particularly in today's environment with its rapid technological changes in materials, processes and products. Use of the link-chain method would simplify dollar-value LIFO calculations and reduce controversies in IRS examinations.

SEC. 7.—LIMITATIONS ON RECAPTURE OF LIFO BENEFITS (ADDITIONAL COMMENTS)

In the event that our Division's proposed repeal of the LIFO recapture provisions contained in section 336 is unacceptable, we agree that modifications to the calculation of the amount to be recaptured are appropriate. It is our understanding that it is your intent to require recapture of the excess of:

1. The LIFO deductions claimed by the taxpayer based on its method of calculating LIFO inventory, over

2. The LIFO deductions that would have been claimed by such taxpayer had it made its LIFO calculations utilizing certain published governmental indices.

The purpose of such provision would be to require recapture of the amount (if any) by which the LIFO benefits obtained by the taxpayer exceed the LIFO benefits based on government published inflation rates. We believe that the present language of the Bill may not convey this intent and is unclear. Accordingly, we suggest that the following language be substituted in section 336(b)(3):

(3) LIFO recapture amount.—For purposes of this subsection, the term "LIFO recapture amount" means the amount (if any) by which—

(A) the lesser of:

- (i) the inventory amount of the inventory assets calculated using the applicable principle selected by the taxpayer under section 472(f) for pricing inventories under such method, or

- (ii) the inventory amount of the inventory assets calculated as if the taxpayer had used the Consumer Price Index for all-urban consumers published by the Department of Labor for pricing inventories, exceeds

(B) the inventory amount of such assets under the LIFO method.

It should be noted that we would propose that the above language apply to taxpayers using both the dollar-value method of pricing LIFO inventories and the specific goods method of pricing LIFO inventories. We see no reason why such provision should not be equally applicable to taxpayers utilizing the specific goods method and do not understand why the current language is limited to taxpayers utilizing the dollar-value LIFO method.

SEC. 8.—CERTAIN SMALL BUSINESSES PERMITTED USE OF CASH RECEIPTS AND DISBURSEMENTS METHOD OF ACCOUNTING WITHOUT REGARD TO INVENTORIES

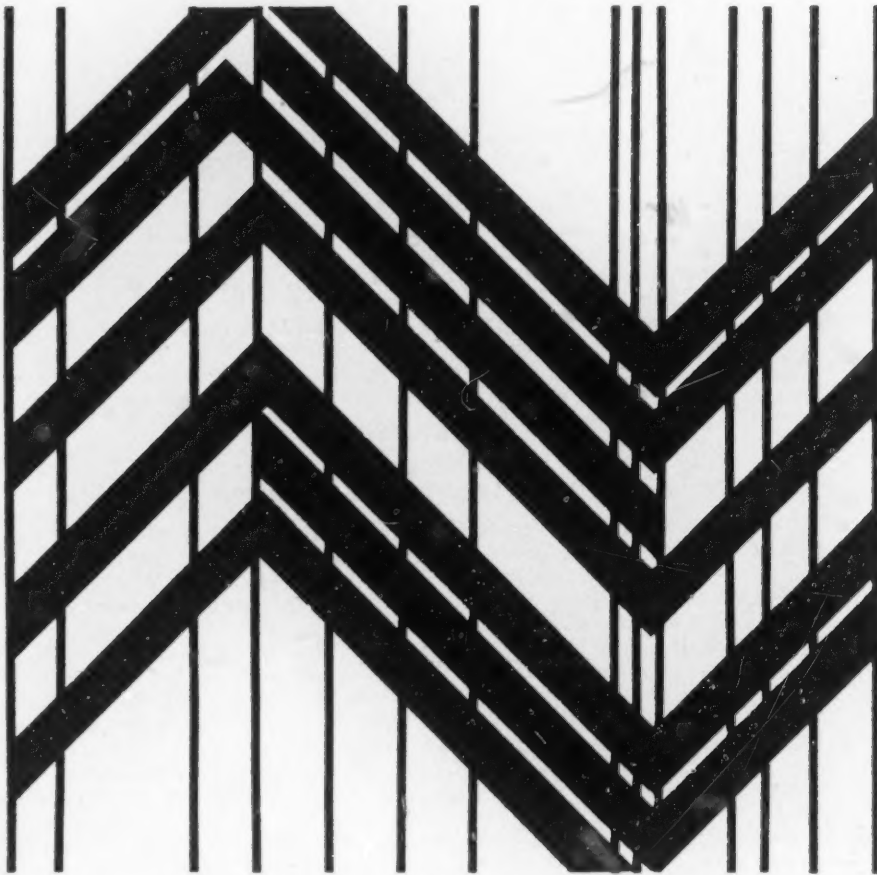
Even though the provisions of Sec. 8 appear to offer safeguards to curb possible abuses if the cash method were permitted for inventory expenditures, I believe it would be in error to legislate change in a well-established generally accepted accounting (GAAP) and tax principle which requires inventories to be taken into account. Both GAAP and tax recognize that the major objective of accounting for inventories is the proper determination of income through the process of matching appropriate costs against revenues. (Accounting Research Bulletin No. 43, Chap. 4, Statement 2; Section 471 of the I.R.C.; Regulations sec. 1.471-1). The disregard of inventories would not conform with the best accounting practice in any trade or business, and would fail to most clearly reflect taxable income.

I do not support the provisions of Sec. 8 of H.R. 3464, even when restricted to taxpayers whose average annual gross receipts do not exceed \$2,000,000 for 3 taxable years ending with the taxable year.

In conclusion, I would like to thank you, on behalf of the AICPA, for the opportunity to appear at this hearing. Mr. Portnoy and I appreciate being able to discuss the important subject of inventories and the need to simplify the rules for LIFO usage.

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RECOMMENDED TAX LAW CHANGES



first occur for purposes of determining whether the requisite 80 percent is acquired during a twelve-month period. However, the ruling points out that the *purchase* of the T stock does not occur until actual direct ownership occurs. Therefore, if actual direct ownership of T is not obtained within the twelve-month period beginning when S is acquired, the liquidation of T into the acquiring corporation will not qualify for section 334(b)(2) treatment, even if such liquidation is pursuant to a plan adopted within two years of the date that 80 percent of the stock of S is acquired.

The situation presented in the ruling may be avoided either by liquidating S within twelve months or by liquidating T into S prior to liquidating S into the acquiring corporation.

This complexity can be eliminated by amending section 334(b)(3) so that the date of purchase is the date the acquiring corporation is first considered, under section 318(a), to own stock of the liquidating corporation.

SECTIONS 336 and 337

Gain on Distribution of LIFO Inventory in Certain Liquidations

Sections 336(b) and 337(f), providing for the taxation of LIFO recapture amounts where inventories are distributed in certain liquidations, should be repealed.

Sections 336(b) and 337(f), added as part of the Crude Oil Windfall Profit Tax Act of 1980, in effect provide for a tax on the disposition of LIFO inventories where section 337 applies or on distributions in liquidation where section 334(b)(2) applies. These changes apply to liquidation plans adopted after December 31, 1981. The addition of these changes to the statute was made by amendment in the Senate without benefit of thorough consideration by congressional tax committees. Further, no public hearings were held to allow public input on what we believe represents far-reaching changes in fundamental tax principles that have been in effect for more than twenty-five years.

We believe that the thrust of these sections is punitive, and they should be repealed. LIFO is an acceptable procedure for valuing inventory that prices (among other variations) inventory on hand at year end as if it were acquired in prior taxable years to the extent that quantities do not exceed those of the prior year. To the extent that prior-year quantity is exceeded, the excess is viewed as having been acquired early in the taxable year. Because of inflation, this inventory, maintained on the books at its cost, frequently will have unrealized appreciation, and it is this appreciation that these sections tax.

The Treasury Department, speaking in favor of the legislation, adopted the view that LIFO is essentially a method for deferring profits. We disagree. LIFO is a technique for determining the cost of inventory on hand and the costs included in the computation of gross income.

There is no logical reason to tax unrealized appreciation in inventory while the appreciation in other assets is not similarly taxed. In fact, all appreciation is in effect subjected to tax in these transactions, but the tax is applied at the shareholder level. These sections, if not repealed, would negate the impact of the only provision in the Internal Revenue Code that mitigates the effects of inflation.

SECTION 337

Collapsible Corporations — Application of Section 337

The nonrecognition provisions of section 337 should apply to sales made by an otherwise collapsible corporation if the relief provisions would prevent the application of the collapsible corporation rules for all of its shareholders [section 337(c)(1)(A)].

At present, the benefits of section 337 are denied to a corporation that falls within the general definition of a collapsible corporation under section 341(b) unless section 341(e)(4) applies. This is true even though the limitations contained in section 341(d) may prevent the application of section 341(a), the operative portion of the section, to all of the shareholders. See *Leisure Time Enterprises, Inc.*, 56 T.C. 1180 (1971), and Revenue Ruling 63-125 (1963-2 C.B. 146).

The reason for the limitation found in section 337(c)(1)(A) was to prevent a loophole through which a collapsible corporation could escape tax on the sale of its property, yet have the shareholders pay the tax on their liquidation gain at long-term capital gain rates. The section was designed to prevent more favorable tax treatment upon a corporate sale of assets pursuant to a section 337 liquidation than was available through a sale of stock by the corporation's shareholders (which was subject to section 341). Therefore, there is no logical reason for prohibiting section 337 treatment in any case where section 341 is totally inoperative.

It is recommended that section 337(c)(1)(A) be amended to eliminate this defect and, at the same time, to refer to the special provisions of section 341(e)(4).

Accounting Periods and Methods

SECTION 471

Inventory Write-Downs

Section 471 should be amended to provide an equitable procedure for valuing inventories and claiming current deductions to reflect the decline in the net realizable value of inventory during the taxable year as a result of excess quantities, obsolescence, style changes, and other indications of subnormal conditions.

The *Thor Power Tool Co.* (439 U.S. 522, 1979) decision has had a significant impact on the inventory valuation methods used by many taxpayers. In that case the Supreme Court interpreted the existing statute to allow deductions for the decline in the value of excess inventories only in the taxable year in which the excess quantities are offered for sale at reduced prices or otherwise disposed of as provided in the regulations. The rules contained in the regulations for determining write-downs are in certain instances more restrictive, or require a greater degree of precision in application, than common business practices today generally provide.

The *Thor* case also contained a factual dispute about allowable write-downs for obsolete, damaged, and defective goods. The IRS contended that such write-downs were allowed because the goods were scrapped by Thor soon after write-down. Thor argued that 40 percent of the obsolete parts remained unscrapped three years later. In this regard, the regulations (section 1.471-2(c)) are ambiguous, and they contain an impractical requirement of an actual offering of the subnormal goods during a period that ends not later than thirty days after the inventory date. In the interest of sound tax administration, there is a need in the law for more certainty, clarification, and recognition of business realities.

The *Thor* decision, in many instances, will result in a significant delay in obtaining tax deductions for inventory write-downs that have occurred economically and have been properly reflected in financial statements under generally accepted accounting principles. This anomaly could lead taxpayers to destroy or otherwise dispose of goods contrary to the dictates of sound business practice solely to secure the benefit of current cash flow from the deductions. The destruction of such items as repair parts could cause the immediate obsolescence of many kinds of consumer and industrial goods, which might result in serious economic consequences. To avoid this problem, we believe the statute should be amended to provide taxpayers with a means of valuing inventories each year at not more than the net realizable value a taxpayer would expect to receive for the goods.

The formula or other methods to be used in computing the inventory write-downs may have to vary by individual taxpayer or industry. We believe, however, that in determining a net realizable value a taxpayer's own facts and recent experience (over the preceding three to five taxable years, for instance) should be used in making the computation.

SECTION 472

LIFO Conformity Repeal

The requirement that LIFO can only be used if it is also used in reports to shareholders, partners, owners, or creditors should be repealed.

Since the enactment of the LIFO provisions in 1939 permitting taxpayers to elect the LIFO method for valuing inventories, the law has required that a taxpayer use the LIFO method in annual reports to creditors, shareholders, or other owners. The legislative history is unclear about the reasons for the conformity.

The LIFO conformity requirement has become burdensome to both the taxpayers and the Internal Revenue Service. In the case of public companies, the IRS has had to make many modifications or exceptions to the requirements during recent years because of increasing disclosure rules mandated by the Securities and Exchange Commission. It has also permitted exceptions in situations where disclosures were mandated by the Accounting Principles Board or the Financial Accounting Standards Board.

Regulations recently adopted by the Treasury Department (section 1.472-2(e)) expressly incorporate the exceptions previously allowed by IRS rulings and, going still further, permit taxpayers to disclose non-LIFO inventory data in footnotes, supplementary financial information, or explanations of their financial statements of income for the taxable year. The

regulations also allow taxpayers to report non-LIFO inventory values for balance sheet purposes, permit financial and tax differences in LIFO inventories, allow write-downs to market value where that is less than LIFO cost, and expressly authorize nonconforming reporting in internal management reports and interim financial statements.

The time has now come to repeal the remaining vestiges of conformity requirements, since they serve no useful tax policy purpose. Repeal will greatly simplify preparation of financial statements, freeing the taxpayers and the IRS from having to deal with rules not affecting tax liabilities. It will also enable investors to make more valid comparisons of financial reports by companies in the same industry and will be more helpful to lending institutions in evaluating financial statements of borrowers or potential borrowers. It will also greatly simplify the ability of small businesses to adopt the LIFO inventory method.

Abolition of the conformity requirements has also been recommended by the Treasury Department.

SECTION 472

Preceding Closing Inventory

The requirement in section 472(d) that the inventory as of the end of the year preceding the year LIFO is adopted be restated at full cost for the year should be repealed. It should be replaced by a provision, similar to section 447(f), providing for restoration of income over a period of ten years, beginning with the year of change to LIFO.

Section 472(d) of the code provides that in determining income for the taxable year preceding the year for which the LIFO method is first used the closing inventory is to be valued at cost. Regulations section 1.472-2(c) provides that the actual cost of the goods included in the opening inventory of the taxable year in which the LIFO method is first used is to be determined pursuant to the inventory method employed by the taxpayer in the prior year, except that restoration is to be made for any write-downs to market value that occurred in pricing these inventories. The commissioner is authorized in regulations section 1.472-4 to determine the adjustments appropriate to the taxpayer's adoption of LIFO; he has ruled that an amended return for the preceding taxable year must be filed with the return for the year in which LIFO is first used. See Revenue Procedure 76-6 (1976-1 C.B. 545), which also states that failure to properly restore such inventory to original cost may result in loss of the taxpayer's election to adopt the LIFO method of inventory.

The current requirement that the closing inventory of goods (whether obsolete, damaged, or excessive) for the year prior to adoption of LIFO must be restored to original cost deters many small companies from adopting the LIFO

inventory method. By filing the amended return for the prior year and paying the tax in full on the restored amount, the taxpayer, in effect, pays for the future benefits of LIFO up front. Preparation of the amended tax return can also result in an additional burden and increased expense to the small business company.

The amended closing inventory for the prior year becomes, of course, the opening inventory for the first LIFO year. The LIFO benefit will not be realized until the LIFO value of an inventory is lower than the value would have been at the lower of cost or market. In some instances, it may take several years to reach this point. In these cases, the reduced cash flow is such a problem that the taxpayer cannot afford to adopt the LIFO method.

A spread of up to ten years of an adjustment caused by a permissible change in tax accounting method, as provided by Revenue Procedure 80-51 in the case of termination of a LIFO election and certain other changes in inventory valuation method, is not available in the change to LIFO because of the IRS requirement to file an amended return for the prior year and to pay the additional tax. There appears to be no sound basis for not treating the write-down restorations like other accounting method changes dealt with in Revenue Procedure 80-51, such as write-down restorations under the *Thor Power* decision, where the Treasury has permitted taxpayers up to a ten-year period in which to spread the adjustment. See also Revenue Procedure 80-5. The motivation for permitting a ten-year spread was, in the Treasury Department's words, "the most practical way of enforcing the Court's decision."

Elimination of the present requirement to restate, at cost, the ending inventory for the year preceding the year of LIFO election should be accompanied by a provision expressly permitting taxpayers to treat a change to LIFO like other accounting method changes initiated by the IRS under section 481 and restore write-downs to income over a period of up to ten years.

SECTION 473

Qualified Liquidations of LIFO Inventories

Section 473 should be amended to make a similar election (or appropriate indication in the tax return filed) applicable to taxpayers in general, and the circumstances of its application should be expanded to include liquidations of LIFO inventories occurring for reasons beyond the taxpayer's control.

At times of national crisis, involuntary LIFO liquidation provisions have been passed into law for temporary periods. The need for such legislation on a periodic basis results in delayed implementation of the relief provision, since

Mr. NOWAK. Well, first of all, let me thank you for taking the time to appear here today. Your association is the most involved with the day-to-day working in this whole area and we appreciate your looking at this on behalf of, I am sure, many who are out there trying to struggle with the maze that exists today.

What we would hope to do is to prepare a full record which we can distribute to not only all the members of the Small Business Committee, but also the Ways and Means members, to have them take another look at what has happened since the 1981 act. We want to see if we can't once again get some input into their hearing process and come up with some of these changes, at least to make it a little easier to not only present but as a practical matter to implement. Let me just ask you a couple of questions.

On a broad base, you had mentioned in your testimony some of the impediments to going over to the LIFO system. I wonder if you could for the committee and other members who aren't here, talk a little bit about the broad impediments that are out there in terms of why more wholesalers and retailers don't go over in terms of cost also.

Mr. JANNIS. Well, I think you start with the initial cost of adopting LIFO. If you are required to restore to cost any write-down taken previously, that is obviously a front-end cost which may take some time to recover. Until the law was changed allowing you to spread such additional cost over 3 years, you used to have to pay the tax up front when you adopted LIFO; therefore, that was an absolute deterrent.

I think the 3-year period was an improvement. The 10 years that you propose should enable people to give more favorable consideration to adoption of LIFO.

The second impediment to adoption of LIFO is that the rules are very complicated. What we have is regulations. The law gives the IRS the right to write the rules and the rules I don't find fault with, although obviously they are subject to considerable interpretation. When it comes to the small businessman, wholesaler or retailer, the subject of pooling is a very difficult subject.

There should be some clear-cut guidelines as to how certain businesses should pool. Unfortunately they are not there and it becomes an uncertain thing after adoption of LIFO whether the IRS will accept what is done, the calculations themselves, because the indexing is also a very difficult problem.

If you have to develop an internal index, that is not an easy task when you are required to use certain methods allowed by regulations, such as double extension or index chain. It is awfully hard to come up with what is an appropriate index so your proposed move to use published indices on a broader base I think is consistent with something that would simplify LIFO for the smaller businessman. Then, I think the other uncertainty is whether or not IRS will approve the LIFO upon examination.

So if you are legislating something which the taxpayers follow, it seems to me they have a much more secure feeling after adoption of LIFO. Repealing the conformity requirement would be great because, even though the rules of disclosure have been relaxed, people still worry about disclosing something which is unauthor-

ized and would lead to the termination of LIFO and repayment of all the tax benefits obtained from its adoption.

I think that about summarizes the concern for the cost factor—that varies by taxpayers—but I have not seen many instances where you don't need professional advice.

Mr. NOWAK. When you go into a firm, or any of your members, and you try to talk about this, I get the feeling it is foreign to the businessman himself. The efforts to try to educate and try to see the impact takes a substantial amount of time, energy, and money to just do that initial investigation. I wonder if you could comment on that, you know, just to discuss it with him to show him what the variations would be and the liabilities and so forth?

Mr. JANNIS. Well, there is no difficulty at all arousing interest in LIFO during periods of rising prices if you can save taxes by adopting a method that is a clearly preferable one. Under the circumstances you always get the attention of someone when you discuss LIFO. It is true that it is an educational process, however, because the rules are not easily conveyed.

The concept is simple. The concept of LIFO is a very simple one. You take your closing inventory at the end of the year and remove from it whatever the price change for the year was. Implementation is not simple although I think that most times it is not a burdensome task. It does take time to explain the rules, why you have to pool, why you have to double-extend or why you have to use price indices. I think the task is not onerous but maybe time-consuming and thus costly.

Mr. NOWAK. Will most clients spend the time to thoroughly investigate it?

Mr. JANNIS. Yes.

Mr. NOWAK. For both the time of their employees, and the cost to the firm?

Mr. JANNIS. In my experience, they will.

Mr. NOWAK. Do you have a comment, Mr. Portnoy?

Mr. PORTNOY. Well, I think that, as you point out, Mr. Nowak, cost-benefit calculations to see what the costs are of implementing versus the benefits and time to have various benefits, it is a time-consuming process and a costly one, but that has been carried out by many larger and medium-sized companies. Smaller companies do have a more difficult time to make that calculation, sir.

Mr. NOWAK. Mr. Vandergriff?

Mr. VANDERGRUFF. Well, in view of the time element, I really think I perhaps should keep my comments to an absolute minimum. I suppose the time element is even more important now, isn't it?

I wish you would spend just a moment more on section 8. It was the only section that, if I gather correctly, you really took an issue with.

Mr. JANNIS. Yes, sir.

Mr. VANDERGRUFF. A substantial issue?

Mr. JANNIS. Yes, I think I take a substantial issue with it because there is a basic principle in accounting, whether for financial statement purposes or for tax purposes, that if inventories are a factor, you should defer the costs in order to properly match revenues and expenses, and I think if you will allow somebody to ex-

pense cash outlay for inventory acquired, it violates what is a basic principle of accounting and I don't think it is appropriate. I think it allows too much abuse, potential abuse.

Although the bill has some curbs in there for abuse, I feel uncomfortable with the cash method because it violates a basic accounting principle.

Mr. VANDERGRIF. All right. I appreciate your comments.

I think I will ask no further questions at this time, Mr. Chairman.

Mr. NOWAK. Thank you.

We also have with us Mr. Smith from New Jersey, who has been very interested in this whole subject of inventory simplification and has spent considerable time and energy on it. I would like to give him an opportunity, although I know it is a short space of time.

Mr. CHRISTOPHER SMITH. Thank you, Mr. Chairman.

I read all of the others. Unfortunately, I didn't have this to review last night but I do have one question, Mr. Jannis. Can you give us an idea as to the cost to a small business using a 3-year averaging versus a 10-year averaging.

Mr. JANNIS. I can't off the top of my head quantify that.

Mr. CHRISTOPHER SMITH. Ball park?

Mr. JANNIS. Ball park, you are going to be paying up front in 3 years what would otherwise take 10 years. So twice the cost at least if you don't allow the 10-year period.

Mr. CHRISTOPHER SMITH. Thank you.

Mr. JANNIS. It costs you money.

Mr. NOWAK. That cost of money is really working capital money too?

Mr. JANNIS. That is correct.

Mr. NOWAK. It is over and above the pure cost of money if you look at the business opportunities that may have to be foregone or the expansion of money for research and development.

I think the whole thrust of what we are trying to put out here to Ways and Means and the other members is that now this may be more critical than ever as we get into a world competitive situation, so-called global trade.

If other countries are providing this kind of assistance, they are going to be able to develop great inroads and we are now beginning to become concerned about the kinds of imports, deficits of trade that may be into the \$100 billion area very, very shortly, in a year or two. This is one area that we could do more in if we had the ability to have the working capital available.

I think for the retailers and wholesalers, looking at the 1981 act, they were shortchanged. Unfortunately, small business got a piece of it but it was a late piece and great emphasis was on the capital expansion, which has not happened. We have had a trend in the country, we have lessened really the capital intensiveness of firms, especially the old line very basic steel and auto and so forth. They were not getting tremendous investments on that end of it, and there seems to be a growing service industry which is growing a lot faster.

We appreciate your testimony and certainly we may have more questions as we try to round out the total testimony. We will try to get back to you with those questions, if we do.

Thank you.

Mr. JANNIS. Thank you.

Mr. PORTNOY. Thank you very much.

Mr. NOWAK. Our next witness will be from the National Farm Power Dealers Association. Mr. Harry Rawley, is president of Valley Implement Sales, Inc., Harrisonburg, Va. He is accompanied by Robert Mothershead, president of the Virginia Farm and Industrial Equipment Dealers Association, and David Ottaway, executive vice president of the Virginia association.

Gentlemen, welcome before the committee.

As stated previously, your full text of your statement will be incorporated in the record and you may proceed as you so desire.

TESTIMONY OF HARRY RAWLEY, PRESIDENT, VALLEY IMPLEMENT SALES, INC., AND DIRECTOR, NATIONAL FARM AND POWER EQUIPMENT DEALERS ASSOCIATION, ACCOMPANIED BY ROBERT MOTHERSHEAD, PRESIDENT, VIRGINIA FARM AND INDUSTRIAL EQUIPMENT DEALERS ASSOCIATION; JOHN J. MULLENHOLZ, LEGISLATIVE DIRECTOR; AND DAVID OTTAWAY, EXECUTIVE DIRECTOR

Mr. RAWLEY. Thank you, Mr. Chairman.

You have received a rather lengthy statement which I don't intend to take your time reading today. With your permission I would like to summarize my remarks and then submit the prepared statement for the record.

Mr. NOWAK. Without objection.

Mr. RAWLEY. Our purpose here today is to tell you that equipment dealers and all small businessmen who use the LIFO method of accounting are in serious trouble. This circumstance arises from a combination of the *Thor Power* decision by the U.S. Supreme Court and the 1982 TEFRA legislation.

The Internal Revenue Service has imposed some impossible requirements with respect to prior excess inventory deductions and the Congress has added some stiff penalties for filing incorrect returns. By and large, the businessmen caught in this vise are honest and hard-working people who do not know how to comply with the IRS requirements and who do not have experts available to tell them how.

What we need is legislative relief which will provide three basic elements:

First, to wipe the slate clean for deductions made in prior years; second, to establish a simple audit-proof method of calculating excess inventory deductions, and finally, to make the system mandatory, in order to prohibit the use of these deductions for the purpose of avoiding income tax.

The bill H.R. 3464 which you have introduced will achieve most of our objectives. However, we believe that H.R. 3802, introduced by Congressman Dorgan, will accomplish all of these goals and we support that bill strongly.

It is also important to note that H.R. 3802 is limited to small businesses.

Mr. Chairman, I would just like to say here that one of the real benefits we see from H.R. 3802 is that this bill is simple and it is fair as we see it. Fair not only to the businessmen but fair to the Government as well, because it would eliminate the abuses taken with inventories as far as taxes are concerned.

We would greatly appreciate anything which the members of this subcommittee can do to convince your colleagues to support and pass this legislation. We need not tell you that Congressman Stark and members of his Subcommittee on Select Revenue Measures are the primary target of our efforts.

We thank you very much for this opportunity to be here this morning and give this report and if you have any questions we would be happy to attempt to try to answer them.

[Mr. Rawley's prepared statement follows:]

PREPARED STATEMENT OF HARRY RAWLEY, PRESIDENT, VALLEY IMPLEMENT SALES, INC., AND DIRECTOR, NATIONAL FARM AND POWER EQUIPMENT DEALERS ASSOCIATION

Mr. Chairman and Members of the Subcommittee, my name is Harry Rawley, President of Valley Implement Sales, Incorporated of Harrisonburg, Virginia and I am a Director of the National Farm and Power Equipment Dealers Association. With me are Mr. Robert Mothershead, President of the Virginia Farm and Industrial Equipment Dealers Association, and Mr. David Ottaway, Executive Vice-President of VFIEDA. The views which we are expressing here today are shared by the many thousands of farm equipment dealers and power equipment dealers throughout the United States. These men and women sell and service the equipment used in agriculture as well as many other industries, such as housing, road and highway construction, and building industries. They handle the products of all of the manufacturers in the United States such as Allis Chalmers, International Harvester, Massey-Ferguson, John Deere, Case, and many, many others too numerous to mention.

We are most appreciative of your providing this opportunity to testify about the Thor Power excess inventory problem. It is our hope that the members of this Subcommittee will be able to assist us in convincing your colleagues of the need for immediate remedial legislation.

We realize that this is a forum for discussing many inventory tax problems, and let me assure you that Farm and Power Equipment dealers throughout the country have confronted every conceivable difficulty in this most confusing area of the law. However, the most vexing and potentially most dangerous issue is Thor Power, so named because of the decision of the United States Supreme Court which reversed decades of tax tradition.

Before describing the details of our dilemma, permit me to explain why this matter has suddenly taken on much greater importance. In 1982, the Congress passed the Tax Equity and Fiscal Responsibility Act. That law significantly strengthened penalty provisions of the Internal Revenue Code, and added new penalties designed to deter tax avoidance. We applaud these efforts by the Congress. Unfortunately, however, these new provisions could have a very serious impact upon dealers, and in fact any small businessman who wrote off excess inventory in past years.

The reason behind this contention is as follows. In 1979, the Supreme Court declared that it was no longer proper to take federal income tax deductions for excess or obsolete inventory below market value or cost, whichever is lower. Generally, this means that no deduction may be taken unless the inventory is scrapped. Immediately following the Supreme Court decision, the Internal Revenue Service issued a proclamation that all previous deductions for excess and obsolete inventory be brought back into income for the year 1979 and that the resulting taxes be paid either immediately or over the next ten years. For reasons which I will describe later, very few businesses were able to follow this directive of the IRS.

As a result, literally hundreds of thousands of businesses are today in violation of the earlier pronouncements of the IRS. There is a very serious question as to whether returns for years subsequent to 1979 must report these previously omitted inven-

tory deductions. If the IRS requirements are indeed applicable to later returns, and if the deductions from earlier years are not reported as income, there is a distinct possibility that the newly enacted penalties could be applied to these current returns, severely injuring many honest businessmen.

In order to understand this issue, it is necessary to review the history of inventory accounting. For many years, it was customary to "write down" a portion of inventory each year due to obsolescence. In fact, the accounting profession demands that allowances be made for obsolescence of inventory in any financial statement. The reasoning behind this procedure is that as inventory becomes older, there is less likelihood that it will be sold and, as a result, it is inappropriate to value it at the price at which it is offered to customers or even at cost. The manufacturer, wholesaler, and retailer, must choose between selling the inventory for salvage value, that is scrapping it, and holding it on the off chance that a customer might need it at some unspecified time in the future.

In some businesses, the former practice is followed because there will never be a market for obsolete goods. However, equipment dealers and many other businesses have customers who own equipment which will inevitably break down and require replacement parts. If the dealer follows a practice of routinely scrapping inventory after it has been on hand for an extended period, say, three or four years, his customers will suffer greatly. The best example I can give you is the farmer whose combine breaks down during harvest. If the dealer does not have a part on hand, he must order it from the manufacturer and significant delays are encountered in locating the part, shipping it to the dealer, and then repairing the piece of equipment. Several days could be lost at great expense to the farmer who might lose his crop or a significant portion of it due to his inability to operate. As the piece of equipment grows older, the situation becomes more desperate because the manufacturer may no longer carry the part and it might be necessary to have the part machined.

Even without the emergency situation I have described, the customer is always the one who loses. It is the customer who will pay the additional freight if the part is not available at the dealership. It is the customer who will pay the extremely high cost of having a part machine made. And finally, it is the customer who will be forced to dispose of a perfectly good piece of equipment due to the lack of a part which was scrapped and is no longer available.

The position of the Internal Revenue Service at the present time encourages dealers to dispose of outdated inventory in order to obtain a tax deduction. This is another example of tax policy favoring bad economic decision. However, there is an alternative.

You, Mr. Chairman, and others in the House and in the Senate, have sponsored legislation which will eliminate the dilemma in which inventory oriented businesses find themselves today. While your bill, H.R. 3464, and several others address the Thor Power problem, I would like to spend a few moments discussing H.R. 3802, introduced by Congressman Dorgan on August 4 of this year. Like your proposal, Chairman Nowak, this bill would permit excess and obsolete inventory to be deducted over a period of years. In addition, H.R. 3802 permits a shorter write-off period and provided safeguards for the Treasury.

One of the major and legitimate complaints which is raised against permitting deductions for loss of value in inventory is that they are used to shelter income. In other words, when a business experiences a lean year it will deduct little or nothing for inventory losses. However, in a good year, inventory losses will be taken in greater than normal amounts in order to avoid payment of taxes.

Congressman Dorgan's bill prevents such manipulation. Once the system of level deductions is adopted, the taxpayer must continue using that method until the I.R.S. agrees that another may be used. Thus, the taxpayer has no option as to the amount of inventory deduction which may be taken. It becomes a rather rigid accounting function.

This raises another most important point. There has been rumors that legislation such as Chairman Nowak and Congressman Dorgan have proposed will cost several billion dollars in lost revenues. In our opinion, based upon what our advisors have told us, quite the contrary is true, and we believe that many in the Department of Treasury agree with us.

When the Thor Power pronouncements came down from the I.R.S., only 1700 businesses complied with them. This figure represents less than 1% of all businesses which use inventories according to I.R.S. statistics. Thus, the vast majority of businesses have failed to report prior inventory deductions and there is good reason to believe that many, if not all, of them are continuing their traditional practice of writing off a portion of inventory each year for tax purposes.

We are not here to tell you that those who blatantly violate the law deserve relief. In fact, most of those who are in violation of the Thor Power decision and the attendant regulations are ignorant of that fact. We must bear in mind that most small businesses do not have the resources to afford the advice and counsel of the major accounting firms. In our particular industry, many of our members are several hundred miles from the nearest "big eight" office.

Consequently, there is a great lack of knowledge as to the proper accounting methods to follow. Some of our members have actually been told by the advisors in their small communities that the Thor Power decision only applies to manufacturers and that they should continue with their customary practice of deducting a portion of their inventory for tax purposes.

You can see, therefore, that it is not defiance or outright disregard of the tax laws which has created the problem. Rather, it is a lack of expertise. I cannot begin to tell you the nightmare which one faces in attempting to reconstruct past inventory, determine how much was deducted for obsolescence, how much was sold in the interim, and then arrive at the correct current figure. I can tell you that dealers have spent many thousands of dollars, one as much as \$40,000, attempting to reach an accurate figure, and even then, no one is absolutely sure that the results are correct.

Our hope is that with the passage of the pending legislation we will be able to handle our inventory tax matters in a simple, fair and honest manner, without the constant fear that a Revenue Agent will one day knock on the door and turn our world upside down. The bills which we support would have this desired effect.

First, they would wipe the slate clean with respect to past deductions. Second, they would provide a certain, audit-proof system of computing these deductions. Finally, they would prohibit abuses in the timing and amounts of inventory deductions.

In closing, let me say that we greatly appreciate all of your help and understanding. We ask that you do everything in your power to convince Congressman Stark to hold hearings on this legislation at the earliest possible opportunity. If we can just bring this matter before the Congress, we know that the justice of our position will prevail.

If there are any questions, we would be pleased to attempt to answer them.

Mr. NOWAK. Fine.

Do any other members of your panel wish to make any statement?

Mr. Mothershead?

Mr. MOTHERSHEAD. Mr. Chairman, I have been in the farm equipment business for many years. To give you one example of what Mr. Rawley is talking about I have one part in inventory which we have had for a number of years. A customer came in, wanting the part, needing the part. He had an old machine. It was debatable whether to repair it or whether to scrap it. He is put in a financial bind either way.

I checked the inventory for the part. The part at this time showed a price tag of \$500 and a few dollars. I checked the inventory and I had had it for many years. I offered it to the customer for some \$400 to get it out of inventory. The customer said no and walked out.

Afterward, I then went back and checked this part. When I originally purchased it, 15 years ago, I had paid \$76 for it. My parts manager and I sat down and figured that with a normal twice-a-year turnover in inventory, making between $\frac{1}{2}$ to 2 percent net profit, the cost of my investment in the part, the interest on my money, at prevailing years, I had \$10 more invested in the part than it would have cost me to buy it from my major manufacturer the same date. The net price of the manufacturer was \$375 on that date, and I actually had \$385 of my money in the part.

Eventually I scrapped the part. That gives you some idea of what we are talking about, because in our industry we must keep up in-

ventory. In order to keep our customers from going under—we must go back many years—for what normally is considered obsolete material and obsolete equipment.

Mr. NOWAK. I think that is often overlooked, the carrying cost you have in those kinds of equipment and parts. How many times would you feel that a particular part that old would be available from the original manufacturer?

Mr. MOTHERSHEAD. In checking on that particular part, it was in a section of our price book that is 12 or less worldwide requests per calendar year. What it says is that possibly they are available from dealers like myself nationwide, not necessarily in a parts depot. They still had the price in the books. There are a lot of parts that today the manufacturers have just dropped because the major manufacturers are cutting back on their available parts. But that doesn't help our customer who has a piece of equipment 15 years old or 20 years old which is still serviceable.

Mr. RAWLEY. Our manufacturers have the same problems with inventories, of course, that we have, and they are cutting back and dropping parts a lot earlier than they used to for these older machines.

Mr. NOWAK. You are not going to have the supply that you used to have?

Mr. MOTHERSHEAD. That is right, and of course our main concern is taking care of our customers, our farmers. Since it is a seasonal type thing, you don't always have time when a machine breaks down in the field at harvest time to have a part made if it is not available.

Mr. NOWAK. Has your organization had any discussions with Treasury with respect to the inventory study that has been going on? Have you had any input directly with Treasury?

Mr. MULLENHOLZ. Yes, sir; Mr. Chairman.

My name is John Mullenholz, the legislative director for the National Farm and Power Equipment Dealer Association.

We sat down with Buck Chapoton at length and talked to him about our problems. I think, if recollection serves me correctly, that in the Barrons article which you mentioned in your opening statement, he spoke of the farm equipment industry as one of the main proponents for change in this area.

He agrees that in this Thor Power area changes need to be made. I don't think he is prepared to agree with our approach nor is he prepared to agree with the 5-year averaging approach that the first witness spoke about. I don't think the folks at Treasury know what they want and I think it is based upon their inability to complete this study.

My reading is that the study has not even been started and I have no idea when it will be started. It is not a priority issue within the Department although it is with Mr. Chapoton. Our hope is that perhaps we could accomplish something before that study comes forward because we need relief right now.

Mr. Rawley pointed out that TEFRA makes it much more serious today than it was in the past.

Mr. NOWAK. Well, that is hopefully one of the aims of this hearing, that knowing there is no movement in this area by the administration, we can encourage the Ways and Means Committee to en-

courage, and by the same token the Treasury, to act to get substantial input because of what has developed here. We would like to work with Treasury to develop some good basic compromise. If they are not going to move, we hope that we can encourage Ways and Means through your organization and others to finally take a good hard look at this and make some substantial changes.

How many of your members would you estimate are using the LIFO method now?

Mr. RAWLEY. Very few I would say that I know anything about, maybe 2 or 3 percent.

The costs of getting into the LIFO method, from what I have investigated, is prohibitive for a small business to do. We just don't have access to the records and knowledge of big accounting firms. These are rural businesses that we represent.

Mr. VANDERGRIF. Mr. Rawley, I don't know that I have fully understood why it is that you have such favoritism for H.R. 3802 seemingly in comparison to this proposal.

Could you enlarge upon your reasons, please?

Mr. RAWLEY. Well, for one thing sir, H.R. 3802 has a faster write-off period you can use. You can write off your obsolete inventory over a period of 3 years.

I think as I have studied it or have read it, maybe I don't understand it altogether, it seems just like a fairer way and simpler way of doing it.

Mr. VANDERGRIF. You spoke of a simplicity. I wonder if there were specific points that you could give to us, such as a faster writeoff?

Mr. RAWLEY. That is one thing, yes.

Mr. VANDERGRIF. Anything else that occurs to you, because I want to look into that bill.

Mr. RAWLEY. It is a set way of doing it so that everybody has to do it the same way rather than being able to manipulate for tax purposes how you handle your write down of your inventory. That is the thing that I think is a good part of that bill and that makes it fair, as far as I am concerned, not only to the businessman who is working under it but also to the Government.

Mr. VANDERGRIF. I see.

All right, sir, thank you.

I don't think I will ask anything more at this time, Mr. Chairman.

Mr. NOWAK. Thank you.

Mr. Smith.

Mr. CHRISTOPHER SMITH. Thank you.

I would like to amplify one of the questions you were getting at, Mr. Rawley.

In light of the *Thor Power* decision, is a farmer who buys a tractor from you also forced to buy the spare parts at the same time because in 3 or 4 years you may not have them?

Mr. RAWLEY. No, sir, he is not required to.

Mr. CHRISTOPHER SMITH. Not forced? I don't mean by law; I mean because of the availability.

Mr. RAWLEY. No, sir; because they depend on us to have those parts 5 to 15 years down the road to service that piece of equipment.

Mr. CHRISTOPHER SMITH. So you will be sure to stock them even though there is a penalty?

Mr. RAWLEY. Yes, sir.

Maybe this would amplify what we are talking about here. Sometimes the manufacturers, when they come out with a new piece of equipment, have what they call a suggested stocking list of parts which they make you buy, a package of parts to be able to service that particular equipment.

Those parts, a lot of times, are not usable parts. The manufacturers think they will be at the time but it turns out that the equipment needs something else. You end up with a lot of obsolete parts.

Mr. CHRISTOPHER SMITH. All the more reason for this legislation. It kicks up your inventory cost, which is one of the main reasons I used to do an inventory on our own small business and it used to greatly disturb me as I would be going through the shelves and counting everything. All this adds to our liability to IRS.

Mr. RAWLEY. That is right.

Mr. CHRISTOPHER SMITH. I know from where you speak.

Mr. NOWAK. Thank you very much.

We wanted to refer to some of your testimony. We talked about this *Thor Power* problem, and quoting just to show why the Treasury has to take a stand here and come up very quickly with something.

On page 6 of your testimony you referred to the *Thor Power* procurements. When it came down to IRS, they said only 1,700 businesses complied with those pronouncements. This figure represents less than 1 percent of all businesses which used inventories, according to IRS statistics. Thus, the vast majority of businesses have failed to report prior inventory deductions and there is good reason to believe that many, if not all of them are continuing their traditional practice of writing off a portion of their inventory each year for tax purposes. Hopefully there will be someone there to see this is more of a priority than they are now considering it.

Again, I want to thank you for your testimony. I think your written testimony is very well reasoned and we will hold the record open as we try to bring all of this testimony together and form a good, hard, pointed consensus for some action here in the Congress.

Thank you very much.

Mr. RAWLEY. Thank you very much.

Mr. NOWAK. Unfortunately, we will have to recess now. The President of Germany is to appear on the floor, and I think it would probably be advisable to recess for 1 hour. We will come back right at 11:30, then try to give everybody else the opportunity to go right through. We will continue through the lunch period if we have to, so that we don't hold anybody over until the afternoon.

Thank you very much.

[A recess was taken.]

Mr. NOWAK. The subcommittee will come to order, and in the interest of trying to catch up because of the interruption in the schedule, we will have the grouping of two witnesses who have some similarity of their views on some parts of the bill.

At this time I would like to call Mr. Eugene O'Connor, who is an associate professor at Canisius College. Mr. O'Connor is an attorney and associate professor of business law at Canisius College in

Buffalo. He obtained his accounting degree from the University of Notre Dame and law degree from the State University of New York at Buffalo.

We want to welcome him along with the representative of the National Federation of Independent Business, Mr. Abraham Schneier, who is tax counsel, and research assistant for the federation. He was formerly a tax accountant for the international firm of Touche, Ross & Co., and we welcome both you gentlemen before the committee.

Mr. O'Connor, your testimony has been received and we will incorporate it in its complete form in the record and you may proceed as you wish.

PANEL CONSISTING OF EUGENE P. O'CONNOR AND ABRAHAM L. SCHNEIER

TESTIMONY OF EUGENE P. O'CONNOR, ATTORNEY, AND ASSOCIATE PROFESSOR OF BUSINESS LAW, CANISIUS COLLEGE

Mr. O'CONNOR. Mr. Chairman, I am delighted to be here today to make some comments about H.R. 3464, which I support very enthusiastically.

The reason for my support of this measure is that with respect to the equities, the capital-intensive industries have received a great deal of attention in the recent Tax Reform Act, and it seems to me that the noncapital-intensive industries deserve the same attention. Certainly the provisions with respect to providing for cash accounting, and also the reforms and LIFO method are desirable and, as far as I am concerned, a necessity at this time.

The first point that I would like to make with respect to the cash-accounting method is that farmers have had this cash-accounting method for years and years and I have never read anywhere in newspapers about any abuses by farmers concerning this method of accounting, whether it be from the point of view of civil abuse or whether it be from the point of criminal abuse.

Given that I have not heard anything about any such abuses, my position is that what is good for the goose is good for the gander; that if the farmer can use the cash method under the provisions of the IRS Code, certainly the small businessman ought to be put in the same position, a sense of fairness and equity demands it.

An additional reason for the cash-accounting methods as far as I am concerned is that the economic climate really demands some kind of tax relief for these people.

From my conversation with the accountants in the Buffalo area, the No. 1 concern has been, well, why should I book and report on the accrual basis a sale and have an income tax liability based on that sale, when I may never receive the income to pay it because of the difficulty of collection, the difficulty of ever receiving that money from the purchaser?

And so, for a lot of reasons, some people have been suggesting to some clients that they forego the use of the accrual method even though this is probably not permitted by the IRS. The economic situation demands that they operate on a cash basis simply to stay alive, and not book into income items which they may never be able to collect.

Additionally, with respect to the cash-accounting method, I would also like to point out that there has been some spurious arguments raised concerning the fact that an adopter of the cash method might perhaps load up on inventory at the end of the first year for the purpose of reducing his income tax. I think that is a frivolous and very, very weak argument.

This theory would require that the adopter, who does load up at yearend, would have to repeat it every year thereafter. To the extent that that repetition was successful, he would also be chasing his own tail to eliminate an income tax liability in the future.

I just don't believe the small businessmen are going to adopt that posture, and use the opportunity to adopt the cash method to cheat the Government.

I believe the law that you are proposing has adequate standards with respect to inventory load-ups so that to the extent there might be some abuses that they will be deterred by the actual statutory provisions if they attempt to illegally acquire an inventory at year-end.

Finally, I would like to say on the issue of LIFO that from my conversations with others and my own view, the LIFO method is so complex that small business won't adopt it even with the amendments that are proposed by H.R. 3646. I have heard figures discussed by accountants saying it would cost anywhere from \$3,000 to \$5,000 in the first year for accounting fees to adopt a LIFO method. The problem is, that in the absence of the kind of dollars that are available for that, people are not going to adopt the LIFO system.

Finally, with respect to LIFO, I would like to say that the write-down of the obsolete inventories is absolutely necessary and is currently being thwarted by the *Thor Power Tool* decision. The forced method with respect to business purchases required that in order to get one product, they buy three others that they don't want and may not be able to sell later on. That extra inventory sits around on their shelves and costs them money to store, and an unnecessary expenditure of cash in the beginning. It seems to me there ought to be some measure of relief to the *Thor Power Tool* dilemma for these unwanted purchases. Your bill does provide a measure of relief for writedown of those inventories which are sitting there and worthless to the small businessman.

Thank you.

[Mr. O'Connor's prepared statement follows:]

PREPARED STATEMENT OF EUGENE P. O'CONNOR, ATTORNEY, AND ASSOCIATE
PROFESSOR OF BUSINESS LAW, CANISIUS COLLEGE

I am pleased to offer testimony today in support of HR 3464, a proposal to amend the Internal Revenue Code to provide simplification of small business inventory accounting rules and to permit the use of the "cash" method of accounting for "qualified small" businesses.

This legislation would make it crystal clear that the Congress has finally heard the cries of the small businessman for help. For too long, the capital intensive industries with their lobbying power have had the legislative ear of Congress.

Tax reforms have been enacted in the last three years to take care of every conceivable interest group. Yet, the vast number of small businesses which generally are not capital intensive, have received no relief from the complexities of inventory accounting. Their capital intensive counterparts have received their "reform" legislation in the enactment of the accelerated cost recovery system which is obviously

designed to increase cash flow. Increasing cash flow is a necessity of non-capital intensive business as well and this legislation does something in this area.

This proposed legislation is justified alone on equitable principles and fairness. It is unthinkable that the Congress could attend to the needs of the capital intensive industries and then ignore those whose activities are primarily relegated to purchasing and disposing of inventories in the normal course of their business.

The economic scene is still unsettled and the rate of bankruptcy and Chapter 11 filings while slowing, shows no signs of vanishing. What sane businessman is going to operate on an accrual basis as is required by our Internal Revenue Code and create accounts receivable, "book" an inventory when the collectibility of many of his sales remain in doubt? An accounting method which creates taxable income and without the assurance of generating a cash flow from receivables to pay the income tax due on it is senseless. And if one thing is certain, it is that "slow pay" and "uncollectible" are words widely heard and discussed in small business today.

By encouraging and permitting the cash accounting method for small business, this Congress will be in the forefront of restoring common sense and equity to our tax system. Farmers have enjoyed the use of the cash accounting method and unless the Internal Revenue Service has information of widespread abuses, equity demands the same system for all others who seek to be self-sufficient and self-employed. What justification can there be for two different sets of tax accounting rules in the United States of America in 1983. I say none.

One of the most difficult positions for the tax advisor is to justify compliance with the complex LIFO inventory rules and at the same time to acknowledge to his client that farmers are permitted to use the cash method of accounting if they are within the statutory scheme of Section 447 of the Internal Revenue Code.

Farmers, if they meet the requirements of Section 447, are exempt from the accrual method and are permitted to use the cash method.

This state of the law is discriminatory towards nonfarmers.

I would suggest that the Internal Revenue Service offer proof, if it exists, of any abuses that it has found in the use of the cash accounting method by farmers, and that the Internal Revenue Service prove whether or not their statistical evaluations of farm operations indicate that there is some widespread cheating going on.

Absent this, it seems to me totally unfair to suggest that the small businessman, the "Mom and Pops" of this world, be subjected to rigorous Internal Revenue Service rules with respect to using accounting and inventory methods established to prevent distortions in income reporting in a big business setting.

The Treasury Department has indicated that they are concerned that the small business corporation would be used as a vehicle for tax shelters if the cash method of accounting is permitted. I would hope that the Internal Revenue Service has data from its evaluation of farm corporations that support this contention. Certainly, the potential for abuse for a farm corporation exists in the area of tax shelters and in the absence of any proof of such abuses, I believe the Internal Revenue Service argument to be without any validity.

The Treasury Department has always alluded to the potential for distorting income that might exist if the cash method is permitted. The expressed fear is that in the first accounting year of the cash method and just prior to the end of the tax year, the businessman will rush out and purchase large amounts of inventory to reduce his taxable income for that year. The source of this inventory technique would be cash or borrowed funds.

That this might occur is a possibility but is it probable? Business is so "cash short" today that the prospect of making untimely purchases of goods is speculative at most. Can we believe that the small businessmen in America, most of whom probably operate on a calendar method, are going to load up on inventory just before Christmas? Sales in the months of January and February are historically slow—that alone would deter many from loading up on inventory to obtain a reduction of income taxes for the current year.

While there undoubtedly will be abuses by some businessmen of this "one shot" income tax reduction via the cash method, the corollary to its one time use must be considered. The next year and every year thereafter, the same technique must be used or the "one shot benefit" of the first year will be lost. The deterrent to widespread abuse of the cash method by inventory acquisitions lies in the requirement of repetitive year to year expensing of these inventory purchases prior to the actual need for such inventory.

If anything, I believe H.R. 3464 does not go far enough—the ceiling on gross sales should be raised to 3-4 million dollars. Two million in sales is a very conservative figure in today's inflationary setting.

As a former Assistant United States attorney, I am fully familiar with the problems of criminal tax prosecutions and the difficulties that the Internal Revenue Service faces in the collection of income taxes from our citizens. However, I have not reached the conclusion that all people cheat on their income tax returns or that the cash method for doing business would be a disaster for the Internal Revenue Service and this country.

I endorse the proposals to simplify the LIFO inventory accounting rules and make it easier to adopt that system.

My associates at Canisius College, Mrs. Robert Davis, Chairman of the Department of Accounting, Dr. Edward Gress and Albert Swiart, Associate Professors of Accounting, possess a rich and diversified background in accounting experience. They unanimously agree that LIFO Inventory Method for tax accounting is not practicable for small business because of its complexity and the cost to install and maintain it. Their conservative projections are that accounting fees of \$5,000.00 or more would be incurred in the first year of adoption of a LIFO system if a company had gross sales of \$2,000,000 and an inventory of \$500,000. That accounting cost is a deterrent of substantial proportions to the adoption of LIFO.

My associates further concluded that the current LIFO rules would require the hiring of additional personnel solely to comply with LIFO methods. This additional expense is also prohibitive.

The Supreme Court decision in *Thor Power Tool Company v. Commissioner*, 99 S.Ct. 773 (1979), illustrates the complexity of the tax law in the area of LIFO inventory accounting. This decision determined that LIFO inventory can no longer be determined on the basis of conforming as nearly as may be to the best accounting practice. The Internal Revenue Service regulations under Section 1.471-2 provides a specific set of inventory criteria, which may not be consistent with the best accounting practice. Yet, the Supreme Court determined that the specific regulations of Section 471 are paramount and must be adhered to notwithstanding that they may well be inconsistent with the mandate and the explicit language of Section 471.

To the taxpayers' amazement, as a result of the Thor Power Tool case, the Internal Revenue Service has by the adoption of an Internal Revenue Service regulation, obstructed Congress' intentions in enacting Section 471.

The impact of "Thor Tool" falls particularly on those businesses that make purchases of large amounts of inventory from one seller because the seller "force feeds" the buyer. By this, the purchaser is required to purchase many items he does not want and cannot sell in order to get the seller's leading product.

The result is a disaster. If he keeps the unwanted goods on his shelves and later decides to reduce the items to "zero" by scrapping or discarding them, current law invalidates the purchasers write down of these items to zero in one year.

The Internal Revenue Service regulations penalize sensible and prudent management decisions about inventory accounting in the aforesaid setting. Instead of being discarded, this inventory remains on the shelves wastefully occupying space, time, and the energy of managers.

Section 9 of H.R. 3464, is commendable in providing a format to resolve the dilemma created by "Thor Tool" and the Internal Revenue Service regulations in the area of inventory writedowns to market.

While the cash method of accounting obviously poses difficulties with respect to the area of cheating, it is interesting to note that in the Thor Power Tool Company case, the Supreme Court recognized that even in the area of inventory accounting, there are abuses committed. The Court noted: "In the light of the well-known potential for tax avoidance, it is inherent in inventory accounting, the Commissioner, in his discretion, may insist on a very high evidentiary standard before allowing write-downs of inventory to market." 99 S. Ct. 784.

Section 9's provisions appear to meet the criteria suggested by the United States Supreme Court.

For all of the above reasons, I believe H.R. 3464 merits serious adoption of the House of Representatives in the United States Congress and that its passage would be a first and worthwhile step in assisting non-capital intensive businesses and reducing the cost of their business and increasing their cash flow.

Mr. NOWAK. Before I enter into some questions, let me call Mr. Schneier for his comments at this time.

**TESTIMONY OF ABRAHAM L. SCHNEIER, TAX SPECIALIST,
NATIONAL FEDERATION OF INDEPENDENT BUSINESS**

Mr. SCHNEIER. Thank you, Mr. Chairman. It seems we have been here before talking about the same subject and NFIB is glad to have had the opportunity to work with both you and your staff on your latest proposals on inventory methods and accounting methods.

We agree with you, the concept of capital formation doesn't extend from a small business perspective to noncapital intensive businesses. We see capital formation needs among inventory intensive businesses as well.

Small businesses are still suffering from high interest rates, which inhibits to a large extent their ability to purchase inventories and to create internally generated capital which might reduce future borrowing needs.

We see the need for many of the simplifications which you have in your bill, and specifically I am going to comment on the section on cash accounting. We have been most anxious to see this proposal investigated more closely by the Treasury Department and tax writing committees.

We believe that the cash method of accounting would not violate any practical accounting concepts for small businesses who are placed in a very difficult situation when trying to deal with the tax rules. Many find that at the end of the year they pay taxes on what they consider to be paper profits.

We have disagreed with various other representatives of the accounting industry concerned for technical purity in accounting. Small businesses need cash accounting for commonsense reasons.

Small businesses are not going to utilize LIFO simplifications, the recommended alternative as they have trouble dealing with many aspects of the accrual method. The concept of when to use the accrual method is very difficult for them.

We feel that tax rules would not be violated. Small businesses especially retailers and wholesalers who would be able to use cash accounting, do not have huge facilities for storing excess inventory, a concern of IRS.

We find that the inventory turnover rate of small business is quite rapid, and at the end of the year they do not have the capability of loading up warehouses with excess inventories which could distort their tax liability, a major concern raised by Treasury.

We feel that the type of safeguards which you have put into the legislation would deal with that problem quite adequately. Providing a definition of reasonable needs of business is what is required.

I might add that this is a concept which is not new in the Internal Revenue Code, it exists in another section dealing with excess accumulated earnings. IRS determines the reasonable capital needs of the business for determining whether or not the company is retaining excess earnings.

NFIB feels that the cash method of accounting basically is a commonsense method that small business may unfortunately be using right now, and we are very afraid they will fall under some severe penalties, given the penalties for substantial understatement of tax

liability, and some of the other TEFRA penalties which were included in last year's legislation.

We do not want to see any of our members penalized as we believe that our members are paying their fair share of tax liability, and we certainly would not want to encourage any kind of tax cheating. We feel that for many small business members the cash method of accounting does make sense, and does deserve a fair hearing.

I would like to add my voice to someone's earlier comment about the study which the Treasury Department was to have made about methods of accounting, specifically it was section 238 of the Economic Recovery Tax Act, which required the Secretary to conduct a full and complete study of the methods of tax accounting for inventory, with a view toward development of simplified methods.

Such study shall include an examination of accounting methods and the cash receipts and disbursement methods. It is of great concern to NFIB that Treasury has not had the opportunity to even begin to develop a study of this kind. Of even greater concern is that the Internal Revenue Service seems to have unilaterally made a decision about the cash method of accounting, by deciding that no one may change to the cash method of accounting if they are currently on the accrual basis.

Many small business owners, when they originally start out, will not know that they might be eligible for different methods of accounting under current rules. The way the most recent IRS rulings procedure has been defined, if they have been on the accrual method, they may never change to cash.

We find it quite disturbing that Congress has specifically asked Treasury to look into whether the cash accounting method is a valid method when all of a sudden, IRS is unilaterally deciding it is not a valid accounting method.

Other sections of this legislation which we find would be useful for some of the larger small retailers and wholesalers are simplification of the last-in-first-out method. We feel that the Economic Recovery Tax Act made a very small beginning in simplification of LIFO and we would hope to see the definitions expanded along the lines which you have discussed and also to see that the regulations which have interpreted those sections are somewhat simplified allowing more small businesses to take advantage of it.

A recent article in *Forbes* termed the way the regulations were promulgated as a practical joke on the small business community, and we would certainly like to see that section of your proposal come to pass.

At this point, I guess I am prepared to answer any questions you might have.

[Mr. Schneier's prepared statement follows:]

PREPARED STATEMENT OF ABRAHAM L. SCHNEIER, TAX SPECIALIST, NATIONAL
FEDERATION OF INDEPENDENT BUSINESS

On behalf of the 560,000 members of the National Federation of Independent Business, I am pleased to be appearing before you today to discuss the subject of inventory accounting and the capital formation process.

The ravaging effects of inflation have largely abated, providing some measure of relief to small firms to utilize accounting procedures which result in overtaxation

from inflated inventory costs. Other concerns remain, for interest rates remain unusually high, causing uncertainty over the future for many small firms.

The NFIB Quarterly Economic Report (QER) for the second quarter of 1983 reveals that 35% of the firms borrowing reported the interest rates they pay are tied to the prime rate, and interest rates for short-term loans generally averaged 13.2%. During the same period of time, rebounding sales resulted in a net decrease in inventory accumulation as small firms were unable to keep goods in stock. Consequently, future plans for inventory accumulation are up, which may affect borrowing needs and credit demands in the third quarter.

This information reflects a continued and growing need for capital, especially by small inventory intensive firms. Short-term needs are being met through borrowings, resulting in expensive credit terms for many small firms. Many larger firms are able to mitigate and reduce a large share of their borrowing needs for inventory because the method of accounting which they utilize allows them to fund purchases through internally generated capital. Small firms are still finding it difficult to generate sufficient earnings to finance large amounts of inventory internally. On a net basis, capital is still a problem for small business, and capital formation through retained earnings is still a goal.

Clearly the need for relief and simplification in the area of inventory accounting remains a major priority for small business. H.R. 3464, introduced by you, Mr. Chairman, and its counterpart, S. 1570, introduced by Senators Mitchell and Durenberger, provide the necessary outline for small business relief from outmoded and over-complicated tax accounting procedures, which are inhibiting the ability of small firms to retain earnings for growth.

CASH METHOD OF ACCOUNTING

Section 8 of H.R. 3464 proposes that small businesses be permitted to use the cash receipts and disbursements method of accounting if the firm has gross annual sales of \$2 million or less. Congressman Nowak, you are only too familiar with this proposal, as you and your staff have introduced similar proposals during the previous two Congresses. We congratulate you on your steadfast determination to insure that this concept, and indeed the whole subject of inventory and accounting rules for small firms, be revised.

Briefly, the cash method would allow a firm to expense the cost of purchases of inventory in the year it is purchased.

Current tax rules specify that the accrual method of accounting must be used by any business in which inventory is an income-producing factor. The accrual method attempts to match costs and expenses by specifying that the cost to purchase inventory is deductible only when the item is sold. While in theory this matching of costs reflects more clearly a business' net income, for small firms it promoted distortions and increased costs, which result in a cash flow problem and increased tax liability.

Having inventory on hand at year end increases a firm's tax liability because the value of the inventory on hand increases the gross income of the firm. This artificially-produced tax liability further exacerbates the cash flow problems of a firm, since it must now borrow more to pay taxes in addition to what was borrowed to finance inventories.

To facilitate an understanding of the small business accounting and inventory methods problem, a simplified illustration of a small retailer is presented below.

Company X sells tables to the public. In 1980, Company X bought 800 tables at a cost of \$50 a table. Each table sells for \$100, and by the end of the year 700 tables were sold. How is profit before taxes determined?

INCOME STATEMENT—COMPANY X

[For period Jan. 1, 1982, through Dec. 31, 1982]

The cash method:

Revenues from sales (700 tables at \$100 a table).....	\$70,000
Cost of goods sold (800 tables at \$50 a table).....	40,000
Gross profit.....	30,000

The accrual method:

Revenues from sales (700 tables at \$100 a table).....	\$70,000
Cost of tables purchased for resale (800 tables at \$50 a table).....	40,000
Cost of unsold tables as of Dec. 31, 1980 (100 tables at \$50 a table).....	5,000
Cost of goods sold.....	35,000
Gross profit.....	35,000

The hypothetical income statement reveals the obvious effects of using the accrual method, which are:

1. A higher tax rate, essentially on the value of the inventory (inventory tax) due to a higher gross profit.
2. Greater borrowing and interest expenses because most small businesses finance inventory through short-term borrowing.
3. Higher accounting fees.

It seems unnecessary and unwarranted to place small firms in such a position that their ability to finance sales is reduced by the need to pay taxes on paper profits. Large firms mitigate much of the problem with the accrual method by using the LIFO method of accounting for inventory and sophisticated computerized accounting controls.

Small business continues to be barraged constantly by new IRS paperwork burdens requiring greater levels of tax and accounting sophistication and resulting in constantly increasing accounting fees.

To allow the cash method for small business would assist those small firms who operate under severe disadvantages and would result in little or no loss of net revenues to the Treasury. Safeguards within the rules for using cash accounting will prevent abuse of this accounting method by insuring that inventory purchases reflect the reasonable needs of the business. The freedom and simplicity of operation which results from the cash method will encourage sales and growth of the business and capital formation.

LIFO SIMPLIFICATION

Simplification of the last-in first-out (LIFO) method of inventory accounting was addressed in the Economic Recovery Tax Act of 1981 (ERTA). Section 235 and 237 of the Act provided new rules that would simplify the use of LIFO indices for small firms, and the number of LIFO pools would be reduced to simplify utilizing the LIFO method.

The regulations later introduced by the IRS failed to interpret the proposals properly; the result was a vastly complex election procedure which proved useless to small firms wishing to use these congressionally-mandated elections.

A recent article in the September 26 issue of *Forbes* termed the IRS regulations on this section of the tax law a "practical joke." Few companies have found that the new approach is either "simplified" or advantageous.

The proposals made within H.R. 3464 for simplification of the LIFO method are very constructive, and we would hope they will become a part of any package which moves forward on inventory reform.

TREASURY OPPOSITION

Section 238 of ERTA required the Secretary of the Treasury to "conduct a full and complete study of methods of tax accounting for inventory with a view toward the development of simplified methods. Such study shall include an examination of the last-in first-out method and the cash receipts and disbursements methods."

We fully recognize that Treasury officials have had a difficult time beginning this study due to manpower shortages and a steady stream of major pieces of tax legislation. However, the study is now almost a full year overdue, with no estimate by Treasury on a completion date.

Compounding this concern is a recently-enacted administrative decision by the IRS which effectively denies a business the ability to change from the accrual method to the cash method under any circumstances.

It appears that the IRS has decided unilaterally that the cash method should not be allowed to anyone. This action flies in the face of several court cases and rulings which recognize the cash method as a method of accounting. Such unwarranted action also challenges Congress, which requested that Treasury review and study tax methods of accounting. Treasury and IRS have taken upon themselves the prerogatives of Congress, which make the law, and declared that they will write the law as it suits their needs.

We therefore recommend that you inquire from Treasury the reasons for the actions they have taken and request to know when they will complete their study on accounting methods. Simultaneously, conversions of accounting methods from accrual to cash should once more be permitted.

CONCLUSION

Few tax legislators would have supported many of the tax simplification rules which are currently incorporated within the tax law several years ago. Clearly, inventory reform is a timely issue, and NFIB looks forward to working with you on seeing your proposals through the legislative process. I am available for any questions you may wish to ask.

Mr. NOWAK. Thank you very much.

I think you make a very good point, and I think the fear that you expressed regarding the penalties under TEFRA may really come to pass very quickly here unless we can get Treasury to start to make a move in this direction and clarify what the small business community can do in this area. How many members do you have in total throughout the country?

Mr. SCHNEIER. Our membership is 560,000.

Mr. NOWAK. Are those 560,000 all active memberships?

Mr. SCHNEIER. Absolutely, yes.

Mr. NOWAK. They pay dues to your organization?

Mr. SCHNEIER. Yes, sir.

Mr. NOWAK. Have you ever broken your membership of 560,000 down to capital-intensive and to labor-intensive firms, wholesaler and retailer versus manufacturer?

Mr. SCHNEIER. We do have that broken down by wholesale and retail sector. If I recall, and I am not sure if I have it in the survey here, retailers and wholesalers are approximately 30 percent of the membership combined.

Mr. NOWAK. So, 30 percent of 560,000 would be 160,000 or so?

Mr. SCHNEIER. That is quite a substantial number.

Mr. NOWAK. Which would probably be indicative of the fact that you have 435 congressional districts and you may have more than one in each congressional district. What we are trying to do, of course, is to alert people not only that TEFRA did not take substantial steps, but in the penalty area, we may have even worsened the impact upon that sector of our business community.

Certainly we helped capital-intensive firms at the bottom. Perhaps it is still a little too early, but I am wondering, are you seeing or hearing from your members, in relation to audits they are now facing regarding this problem?

Mr. SCHNEIER. We are beginning to hear some. Like you say, it is just a little early at this point, because some of the TEFRA rules did not become effective until January 1, 1983. The cycle won't be fully implemented for another few months.

We have begun to hear from members who have been awakened by their accountants as to the problems they may face in certain areas, the additional paperwork requirements, with which they are being faced, the additional penalties that they may face if they fail to supply an identification number of someone which they have done business with or have used for a service in their business. As to the red flag provision, the substantial understatement penalties, we haven't heard any comments yet, because I suspect that they haven't heard about it.

It is possible their advisers are not willing to tell them that they might be subject to penalty for mistakes that they might make.

Mr. O'CONNOR. On that point, I think that the audit process is going to take 3 years. You are looking to 2 to 3 years down the road from the passage of the penalty legislation to its implementation.

I don't think you are going to see much activity in that area until 1984 or 1985 when the audit reviews are going to be completed for purposes of the civil statute of limitations reassessing fines and penalties.

That is when the action is really going to take place.

Mr. NOWAK. My point is, I guess, if there was some way we could start alerting the tremendous numbers of small businessmen out there to the potential of this problem, perhaps we could get their input into their own congressional district or their congressional Representative.

If in 3 to 5 years we are still sitting here with no progress and you have an avalanche of audits and avalanche of these problems, we are going to be looking at a problem retroactively instead of prospectively, so hopefully, one of the options would be to energize all groups out there with membership. I will have my subcommittee counsels, Benson Goldstein and John Caulfield, working on some kind of an alert system for the small business community. Perhaps in communications between the organizations here and the membership, we would be able to put something together that makes some sense, both of alerting them to the possibility of a problem, and by alerting their own representatives in the area.

We are going to move this forward. It is my sense that we need a tremendous amount of cosponsorship to put the kind of pressure both on Treasury and on the Ways and Means Committee. I am happy to hold the hearings, if that is all we accomplish. I think the detail that we are receiving here will give anybody enough background so that when they are called upon, they will have the reference material in order to intelligently pass upon this somewhat difficult legislation even if you are not an accountant or haven't dealt with the small business community in some regard.

One thing that is referred to over and over again by Treasury as one of the reasons there is no priority is that somehow this is a cash accounting problem, and somehow there is a reaction that this is going to lead to terrible management of the small business because of the use of the cash method.

You both mentioned that as something you don't believe would take place. I wonder if you could expand upon that point.

Mr. O'CONNOR. Well, with respect to my own views on that subject, I think that anybody who suggests the management—

Mr. NOWAK. You were also, Mr. O'Connor, I believe, assistant U.S. attorney?

Mr. O'CONNOR. Yes, sir.

Mr. NOWAK. During your year—and you have had some dealings with, Treasury, I am sure—I wonder if you believe, based on that background, that perhaps Treasury is a little too preoccupied with the so-called tax shelter abuse.

Mr. O'CONNOR. I think their focus is a negative focus. It is a deterrent to good small business practices and good business sense.

The provision with respect to the cash accounting method makes for good business, it makes a business easier and simpler to run.

A suggestion that small businesses are not going to be able to manage their affairs because of adopting the cash accounting method is a frivolous one. Because of the fact that these people still have to borrow money, still have to have a statement put together, for accounting purposes, to influence their bankers, will require sensible and efficient management.

The accountants of the world are not going to be frozen out of servicing small business, and as long as accountants are involved in the process, you are going to have what I consider to be an adequate measure of management expertise imposed upon the small businessman with or without his consent.

Mr. SCHNEIER. Certainly the concern that small business owners would make decisions based on the tax advantages that they could gain from utilizing the cash method, we feel is a very suspect argument.

For the most part, the small business owners who would probably be able and want to take advantage of the cash method, would not have the financial wherewithal to go out and purchase large amounts of inventory at yearend.

We feel that those members, those individuals who would use the cash method under this system which has been proposed, would be using it under what they consider to be proper management procedures.

It simplifies dramatically their recordkeeping, their ability to know how much inventory they have on hand or how much inventory they have to pay. As I said earlier, in small business inventory turns over quite rapidly. The owner has the hands-on knowledge of what he has in stock at any one given day, not the accountant who maybe comes in quarterly or on an annual basis. It is the business owner who has to understand what he has and what he doesn't have, and the cash method is the way his mind fix tends to work.

He understands that method much more easily than he would an accrual system involving possibly a LIFO election.

Mr. NOWAK. Also, another point that may come into play here. I think partly due to deregulation, the bank system is going out borrowing at rates that are available now, and when you figure in the rates that small business pays, which is 2 to 3 cents over the prime, that inventory sitting for 3 to 6 months' period, would probably overwhelm any tax consequence. So from the changes in the interest rate structure of this country, where perhaps at one time we were subsidizing the interest rate, now, being out there in a competitive community would certainly, in my mind, work against making a management decision that could be just a tax avoidance scheme.

I think that as a practical matter that has a bearing, and I hope the Treasury will look at that also.

Mr. SCHNEIER. That is an alarming trend. You are quite right, our recent survey shows 35 percent of our members who are doing short-term borrowing have their interest rates tied to the prime plus 2 or 3 points, and even though interest rates have come down somewhat, they are still paying quite high cost for their funds and

short-term borrowings for inventory purposes does not make sense if it is just to let inventory sit on the shelves of a warehouse.

Mr. O'CONNOR. The point is that at the end of the year, they are certainly not going to borrow money at high rates to get a tax benefit that year for what is a "one-shot bite of the apple."

Mr. NOWAK. To carry that inventory from what would be their normal sales, that so-called benefit would be eaten up, plus, throughout the year.

I want to thank you very much for your testimony. I think your statements gave a good broad look at this, and once again, as we get along, we want to do everything we can to encourage not only the Congress, but in the short-term here, the Treasury to take another look at this thing and hopefully encourage them to bring forth a good, solid recommendation to Ways and Means, so that we can put, as you folks said, some fairness and equity into the whole area of inventory accounting.

Mr. O'CONNOR. Thank you.

Mr. NOWAK. Thank you very much for your testimony.

We will have now as a panel, the National Association of Wholesaler Distributors, represented by John Fitch, who is the vice president for government relations. Mr. Fitch is no stranger to our committee, he has testified before us on such issues as the State tax and gift reform, general capital formation issues, in addition to inventory simplification. He has certainly been an active supporter of the capital formations task force on inventory.

Also appearing with him will be the National Shoe Retailers Association representative, James M. Goldberg, who is general counsel for the association. Mr. Goldberg is an attorney in private practice with the firm of Abrams, Kovacs, Westermeier and Goldberg. He spends most of his time working with various trade associations. In addition to the National Shoe Retailers, he also represents the National Association of Music Merchants and the National Association of Retail Dealers of America, and the National Lumber and Building Materials Dealers Association. So he comes with a broad base of interest out there.

Mr. Fitch, if you will begin your testimony, then we will turn to Mr. Goldberg.

PANEL CONSISTING OF JOHN H. FITCH, JR., AND JAMES M. GOLDBERG

TESTIMONY OF JOHN H. FITCH, JR., VICE PRESIDENT, GOVERNMENT RELATIONS, NATIONAL ASSOCIATION OF WHOLESALE- DISTRIBUTORS

Mr. FITCH. Thank you.

I will submit my entire statement for the record and just summarize it.

For wholesaler-distributors, Federal tax policy relating to inventory valuation is a critical capital retention issue. In times of inflation and high interest rates, it can facilitate the needed operating capital without the necessity of accessing external capital markets.

Moreover, since the average wholesaler-distributor has 80 percent of his investment in inventory and receivables, the tax treatment of those assets will determine to a great extent the price and

availability of replacement parts and equipment. On the average, it costs an additional 40 percent per year to maintain inventory.

In the current economic environment, sound tax policies that put certainty in the law and which stimulate and encourage competition and productivity are essential. This proposition was underscored by Congress in 1981 with the enactment of the accelerated cost recovery system for capital-intensive firms.

Revitalization of the \$1 trillion inventory-intensive wholesale distribution industry is a key element in advancing the public policy goals stated above and fostering a strong economy recovery.

Let me move into some of the areas which the bill covers and which our industry is very much concerned about. I would first like to talk about the writedown of slow-moving or obsolete inventory.

NAW conducted a survey of our members on the writedown issue in 1980, and the results I have included in my statement. I will just briefly summarize it here.

The results but for some slight commodity line-specific deviations, clearly indicate that the IRS position, as upheld by the U.S. Supreme Court in the *Thor Power Tool Co.* decision, has put wholesaler-distributors "between a rock and a hard place," that is to comply with *Thor*, "excess" inventory will be scrapped or will be retained for shorter periods of time, causing higher prices and reduced numbers and availability of replacement parts of equipment. I think the farm implement dealers evidenced that quite clearly in earlier testimony.

Moreover, the remedy of switching to LIFO has been rejected by a preponderance of the companies complying with *Thor* based on the severe and immediate tax consequences resulting from the switch to LIFO, and the complexities of LIFO once the switch has been made.

The survey also substantiates the presumption that smaller businesses are on FIFO, and larger businesses on LIFO. However, it also points up the fact that even given a simplified LIFO, close to 20 percent would stay on FIFO for other reasons; thus, a need to conform the lower of cost or market valuation method to actual business practices.

The public policy implications based on these data are quite obvious. Without LIFO simplification and a more reasonable and equitable method to value excess inventory, consumers will not have readily available spare parts for their major home appliances, heating and air conditioning units, et cetera, and will pay significantly higher prices for those that are available. The same is true for the industrial customers of wholesaler distributors who rely on the immediate availability of parts for their machines and equipment used in the manufacture of products.

For business, the ramifications are even more significant. The most serious scenario would be that manufacturers would produce less; wholesaler distributors would retain and distribute less; retailers would have less to sell; profits would be down, unemployment up; and the entire business sector would remain quagmired in a perpetual recession.

These results clearly support NAW's strong interests in and endorsement of H.R. 3464 to correct this problem and the commitment of its resources to ensure its enactment.

Let me now go to some of the LIFO issues that we believe need congressional attention.

The first one on our list is the repeal of the LIFO recapture provisions of the Windfall Profits Tax Act of 1980. Currently, the LIFO reserve of a corporation that liquidates under section 337 of the Code will be taxed as ordinary income. This provision is punitive and works an extreme hardship on family-owned, closely-held firms such as wholesaler distributors.

The provision's effective date was postponed for 2 years in order to give Congress an opportunity to hold hearings and receive public comments. No hearings had been held on the issue. To date, Congress still has held no hearings on the merits of the issue. NAW urges repeal of the provision or in the alternative, as set forth in section 7 of H.R. 3464, recognize the concept of recapture but only recapture the difference between the CPI/PPI value of the inventory and its actual price.

Other LIFO simplification measures we support are: increasing the one pool test to \$10 or \$15 million in annual gross sales from current \$2 million level. Your bill calls for \$8 million. In order for this provision to be useful in the practical sense, the threshold test must be raised.

Allow 100 percent PPI/CPI indexing for valuation purposes. Currently only firms with annual gross sales of \$2 million or less can do this. All others must value at 80 percent of CPI/PPI, a difference without a distinction.

We also support AICPA in their suggestion that we use the link chain valuation method when internal indexes are used. We think that is a very important simplification item.

We also support and advocate limiting the number of pools to 15 major PPI categories—11 CPI categories—with further detailing left to the taxpayer. Once that detailing has been made, then the taxpayer making that election must get the permission of the Commissioner to change. That proposal is a major simplification for wholesalers.

We also agree that there is a need to increase from the current 3 years to 10 the number of years a taxpayer has in which to bring back into income writedowns under FIFO when they switch to LIFO. One of the things that our survey pointed out was the tax consequences related to switching to LIFO. This change would alter many of our members to switch over to LIFO.

We also suggest that wholesalers be allowed to spread over 10 years the restoration to income for those who elect LIFO while they are on the 10-year spread in accordance with the 80:5 on restoring writedowns according to the *Thor* case.

H.R. 3464 and its companion bill in the Senate, S. 1570, cosponsored by Senators Mitchell and Durenberger will transform the current archaic inventory valuation system to a modern, simplified and equitable system that recognizes the current business investment and operating needs of inventory intensive businesses such as wholesaler distributors.

In that regard, I would like to point out that in April 1983, the SBA National Advisory Council unanimously adopted a resolution that calls for the "simplification and reform of the LIFO and FIFO inventory valuation tax laws, including repeal of the LIFO reserve

recapture law." This certainly reflects the overall view of the small business community on this issue.

Mr. Chairman, I would be remiss if I did not address the 1981 revenue estimates for H.R. 2319 which have been attached to H.R. 3464.

First, in our judgment, the application of 1981 estimates to a late 1983 bill is highly misleading. The economic conditions have dramatically changed and the economic assumptions related to such estimates must necessarily be revised in order to accurately reflect those changed conditions.

Second, while the bill may have some short term revenue loss, in the long run, the economic benefits of the bill will result in increased revenues to the Treasury as corporations become more competitive, efficient, and consequently more profitable. Even now, the effective tax rate for the wholesale distribution industry is approximately 36 percent. Our industry pays a lot of tax both Federal and State, therefore, it is difficult for us to understand how H.R. 3464 would cause substantial loss to the Treasury.

Finally, Mr. Chairman, I would like to request that you, as chairman of this subcommittee, inquire in a formal communication to Assistant Treasury Secretary for Tax Policy, Chapoton, on the status of the inventory study the Treasury Department was required to have completed by December 31, 1982, under the provisions of the 1981 Economic Recovery Tax Act. It has been almost a year since the due date and to my knowledge the mandated study has not been submitted to Congress.

While I understand the burden under which the Treasury Department technical staff has been laboring, it does not excuse their lack of attention to this study. It would appear that a congressional inquiry will be necessary to move Treasury to respond.

Mr. Chairman, I also would be remiss if I did not personally thank you, your subcommittee and the staff for the years of hard work and dedication you have shown in advocating legislation such as H.R. 3464. It is not a politically attractive issue and, therefore, it is difficult to get your colleagues interested in it.

However, the wholesale distribution industry and other small business groups believe it is vital to their survival and we appreciate and recognize your efforts and will continue for as long as it takes to seek enactment of this critical legislation.

Thank you.

[Mr. Fitch's prepared statement follows:]

PREPARED STATEMENT OF JOHN H. FITCH, JR., VICE PRESIDENT, GOVERNMENT RELATIONS, NATIONAL ASSOCIATION OF WHOLESALER-DISTRIBUTORS

Mr. Chairman, Members of the Subcommittee, my name is John H. Fitch, Jr., Vice President, Government Relations, for the National Association of Wholesaler-Distributors.

It is a pleasure to appear here today to express the views of NAW on H.R. 3464, the Inventory Simplification and Reform Tax Act of 1983.

Before I begin my testimony, I would like to commend you, Mr. Chairman, the cosponsor of the bill (and its Senate companion, S. 1570) for recognizing an important, but highly technical, capital retention issue—particularly for inventory-intensive wholesaler-distributors.

NATIONAL ASSOCIATION OF WHOLESALE-DISTRIBUTORS

The National Association of Wholesaler-Distributors is a federation of 120 national wholesale distribution associations which have an aggregate membership of approximately 45,000 wholesaler-distributors, with 150,000 places of business. The members of our constituent associations are responsible for 60% of the \$1.4 trillion of merchandise which will flow through wholesale channels this year, according to the Commerce Department. They employ a comparable percentage, or 3 million, of the 5 million Americans who work in wholesale trade. Thus, although the individual firms which our organization represents are small- to medium-sized business individually, their collective economic importance is most significant. A list of NAW's Association members is provided at Appendix A.

THE INDUSTRY

The Wholesale distribution industry, in contrast to the manufacturing sector of the economy, continues to be dominated by small- to medium-sized, closely-held, family-owned businesses. Of the 238,000 merchant wholesaler-distributor corporations filing tax returns in 1977, 99 percent had assets of \$10 million or less. These smaller firms accounted for about 58 percent of the industry's sales volume. In contrast, in the manufacturing sector, approximately 2 percent of the firms controlled about 88 percent of the assets and accounted for approximately 80 percent of sales.

The wholesale distribution industry provides year-round employment for over 5 million individuals. With an average work week of 38.3 hours and an average hourly wage of \$7.65. In short, the wholesale distribution industry provides dependable, well-paying jobs throughout the U.S. economy.

Productivity wise, the wholesale distribution industry over the period of 1947 to 1980 grew at an average annual rate of 2.8 percent (measured by output per employee hour). The industry expects that percent to grow significantly due to greater efficiencies brought on by computerization, employee education and training, improved employee incentives, and diversifying markets and lines.

Industry sales totaled approximately \$1 trillion in 1982 and are expected to reach over \$1.4 trillion in 1983, according to United States Commerce Department estimates. The total wholesaling industry's share of the GNP is 7 percent and growing at an annual rate of 5 percent.

Merchant wholesaler-distributors perform an essential economic function. They make goods and commodities of every description available at the place of need, at the time of need. Wholesaler-distributors purchase goods from producers, inventory these goods, break bulk, sell, deliver, and extend credit to retailers and industrial, commercial, institutional, governmental and contractor business users. Many wholesaler-distributors also assemble, fabricate and process goods according to the needs of their customers.

Wholesaler-distributors are essential to the efficient satisfaction of consumer and business needs. Further, by the market coverage which they offer smaller suppliers and the support which they provide to their customers, wholesaler-distributors preserve and enhance competition, the critical safeguard of our economic system. According to an NAW survey, the typical wholesaler-distributor established the market connection between 133 manufacturers and 533 business customers. Many of these manufacturers are themselves small businessmen who must rely on wholesaler-distributors to establish, maintain, and nurture markets for their products. The majority of customers are small businessmen, also, who look to the merchant wholesaler-distributor to provide merchandise availability, credit and other critical services.

According to IRS figures, most recently available (1979), corporate wholesale distribution firms have pre-tax profits of \$18.6 billion and paid \$7.3 billion in taxes!

Wholesale distribution is an inventory-intensive business. Virtually 80% of a wholesaler-distributor's asset base is inventory and receivables. Therefore, with the high cost of money and moderate inflation, the cost of maintaining proper and adequate inventory levels has risen sharply.

Consequently, the method used to value that inventory must be based on economic and business considerations in order to ensure sufficient cash flow from retained earnings to support operations and growth.

The current high interest rate and moderate inflation environment not only exacerbates the problem, but coupled with a tax system that fails to recognize the actual business practices and accounting methods used to value that inventory as under the FIFO (first-in-first-out) method, or needlessly complicates the method as is currently the case with LIFO, it even further intensifies the problem.

H.R. 3464 substantially and adequately provides solutions to both problems and is therefore vital to the ability of wholesaler-distributors to become more efficient and competitive in the current and future domestic and international business environment in which they must operate.

Let me briefly discuss the issues as they relate to wholesaler-distributors and then specifically evaluate the bill within that context.

OBJECTIVE WRITE-DOWN STANDARD FOR FIFO USERS

Pursuant to the U.S. Supreme Court decision in *Thor Power Tool Co. vs. Commissioner* 439 U.S. 522 (1979), the Internal Revenue Service issued Revenue Ruling 80-60 and Revenue Procedure 80-5.

In the *Thor Power* case, the taxpayer used the "lower of cost or market" method of valuing inventories for both financial accounting and for income tax purposes. The taxpayer wrote down what it regarded as "excess" inventory to its net realizable value which, in most cases, was determined to be scrap value. The taxpayer determined that these articles were "excess" inventory because they were held in excess of any reasonably foreseeable future demand although such inventory was not scrapped or sold at reduced prices. The taxpayer retained the excess items in inventory and continued to sell them. The taxpayer contended that by writing down "excess" inventory to scrap value, it thereby reduced its inventory to "market" (net realizable value) in accord with its "lower of cost or market" method of accounting. The Commissioner of Internal Revenue disallowed this write-down.

The Supreme Court in *Thor Power* stated that sections 446 and 471 of the Internal Revenue Code vest the Commissioner with wide discretion in determining whether a particular method of inventory accounting should be disallowed as not clearly reflecting income. The Court affirmed the lower court's decision, sustaining the Commissioner, that although the taxpayer's write-down of excess inventory did conform to the best accounting practice in the trade or business and thus satisfied the first test of section 1.471-2(a) of the regulations, it failed to satisfy the second test of section 1.471-2(a), that it clearly reflect the taxpayer's income. The Court stated that where a taxpayer, under the "lower of cost or market" method of accounting, values its inventory for tax purposes at "market" (replacement cost), the taxpayer is permitted to depart from replacement cost only in specified situations described in sections 1.471-2(c) and 1.471-4(b) of the regulations. When such a departure to a lower inventory valuation is made, the regulations require that it be substantiated by objective evidence of actual offerings, sales, or contract cancellations and further require that records of actual dispositions be kept. The Court concluded that because the taxpayer provided no objective evidence of the reduced market value of its excess inventory, its write-down was plainly inconsistent with the regulations and was properly disallowed by the Commissioner. The taxpayer could not have properly taken advantage of any permitted write-downs since it does not scrap its "excess" inventory nor sell or offer it for sale at prices below replacement cost.

The *Thor Power* case affirmed the method of accounting for inventory valuation established under the income tax regulations where the lower-of-cost-or-market method is applicable. In using the lower-of-cost-or-market method, the regulations require a taxpayer having "excess" inventory to value such "excess" inventory at replacement cost (if lower than actual cost as defined in section 1.471-4 of the regulations), unless the goods have been scrapped or have been sold or offered for sale (at a lower price) within the meaning of the regulations under section 471 of the Code. (The "prescribed method.")

In Revenue Procedure 80-5, the Commissioner has granted consent for taxpayers to change from a method of accounting for inventory valuation of "excess" inventory, that is not in accordance with the "prescribed method." The Commissioner's consent is applicable for the taxpayer's first taxable year ending on or after December 25, 1979. In order to implement the decision of the Supreme Court and under the authority contained in section 1.446-1(e)(3)(ii) of the regulations, the Commissioner has prescribed certain procedures with respect to the change in method of accounting including a provision that will allow taxpayers to treat the change in method either as a change initiated by the taxpayer or as a change not initiated by the taxpayer.

NAW strongly supports the position that business should have available a choice of LIFO and FIFO rather than being forced indirectly to adopt LIFO. As shown above, present Treasury rulings require either an offering at the reduced price or scrapping to support FIFO write-downs. Neither method is applicable to a wholesaler-distributor's inventory. A retailer can reduce his entire stock of men's trousers below cost and expect to sell all or a large percentage at the reduced price, but the

likelihood of a parts distributor selling his entire line of slow-moving or obsolete parts at reduced prices is almost nonexistent.

Relegating potentially usable, but not currently salable, parts to the scrap pile is equally absurd. Not only are the economy and consumer impacted by the total unavailability of replacement parts for older units, but the distributor bears the cost of model or other changes mandated by the manufacturer. Moreover, in the case of long-lived assets—such as industrial and commercial tools and equipment, consumer appliances, and heating and air-conditioning units—the wholesaler-distributor has an agreement with the customer (generally a manufacturer or retailer) to keep spare parts for those items on hand for the life of those assets for quick availability.

A valid formula write-down procedure, as set forth in H.R. 3464, would more accurately reflect the conditions that exist in a wholesaler-distributor's inventory as they concern obsolescence or slow-moving items and should be enacted. Obsolescence and slow-moving parts for long-lived assets cannot be ignored; they are real and must be dealt with—not by rules which have no relationship with economic reality, but by a reasonable, rational approach that this Subcommittee can provide. We believe H.R. 3464 does just that.

In order to provide the Committee with a more graphic and statistical grounding for this position, a summary analysis of data taken from a survey of all 120 national commodity line associations members of NAW is set forth below. The figures are quite revealing and strongly support the position set forth in this bill.

**GENERAL ANALYSIS.—National Association of Wholesaler-Distributors Summary
Analysis of 1980 Thor Survey***

Responses: 1909.

	Survey total (percent)
Gross sales volume:	
\$0 to \$500,000	0
\$500,000 to \$1,500,000	10
\$1,500,000 to \$3,000,000	17
\$3,000,000 to \$5,000,000	17
\$5,000,000 to \$10,000,000	23
\$10,000,000 to \$15,000,000	12
\$15,000,000 to \$20,000,000	6
Over \$20,000,000	16
What is your current inventory valuation method?	
LIFO	53
FIFO	36
Other	10
Given Thor decision, will you change to LIFO:	
Yes	17
No	84
If "no," because:	
LIFO statistics and records too complicated	56
Immediate tax consequences too severe	21
Other	17
Given Thor decision, have or will you change policy regarding retention or scrapping old inventory items?	
Yes	61
No	39
If "yes," what change?	
Offer affected inventory at reduced prices	39
Retain affected inventory for shorter period	25
Scrap affected inventory	42
Other	5
If inventory practices are changed, what might be consequences for your cus- tomers?	
Higher prices	31
Reduced number and availability of spare parts	47
Forced obsolescence	32
Other	8
What advice did you receive from accountant or others?	
None	32
Change to LIFO	17
Offer affected inventory at reduced prices	36
Retain affected inventory for shorter period	18

	Survey total (percent)
Scrap affected inventory	36
Other	8
Consistent with Revenue Ruling 80-60, if there is an offer to sell inventory at reduced prices, are writedowns practical?	
Yes	44
No	57

* Percentage totals may not total 100% due to rounding off of figures or multiple answers.

There were 1,909 responses from individual corporations representing 92 commodity lines. This represents 78% of the total number of commodity line associations.

Of those responding, 1,019, or 53%, indicated they were on LIFO; and 887, or 46%, indicated their accounting method was FIFO or other.

If terms of company size, 67% of the respondents had gross annual sales of \$10 million or less, and 44% had annual gross sales of \$5 million or less.

Broken down according to LIFO and FIFO, 55% of those in LIFO had \$10 million or more in annual gross sales; 45% had \$15 million or more in gross sales; and 23% had \$20 million or more in gross annual sales.

Conversely, 80% of those respondents who indicated they used the FIFO method of inventory valuation had gross annual sales of \$10 million; and 55% indicated gross annual sales of \$5 million or less. This clearly shows that smaller businesses use the FIFO method rather than LIFO.

Of those respondents on FIFO, 84% indicated they would not switch to LIFO given the U.S. Supreme Court decision in *Thor Power Tool Co.*

Of that 84%, 56% indicated that their reason for not switching to LIFO was its complexity, while 21% would not switch because immediate tax consequences were too severe.

In response to the question regarding what charges would be made to accommodate the *Thor* decision, 67% of the respondents indicated they would retain the affected inventory items for a shorter period or scrap them.

In determining what economic consequences that action would have, 78% of the respondents indicated higher prices and a reduced number and availability of spare parts.

Finally, 57% of the respondents indicated that for a wholesaler-distributor, it was impractical to offer to sell affected inventory at reduced prices before writing it down. This is based on the nature of the wholesale distribution industry in that its customer base is industry, retailers, commercial or government users whose purchasers are stimulated by need rather than price. Thus, offering goods at reduced price will not, per se, produce a sale.

Without a doubt, the results of the survey, but for some slight commodity line-specific deviations, clearly indicate that the IRS position, as upheld by the U.S. Supreme Court in the *Thor Power Tool Co.* decision, has put wholesaler-distributors "between a rock and a hard place"; that is, to comply with *Thor*, "excess" inventory will be scrapped or will be retained for shorter periods of time, causing higher prices and reduced numbers and availability of replacement parts and equipment.

Moreover, the remedy (switching to LIFO) has been rejected by a preponderance of the companies affected by *Thor* based on the severe and immediate tax consequences resulting during the switch to LIFO, and the complexities of LIFO once the switch has been made.

The survey also substantiates the presumption that smaller businesses are on FIFO, and larger businesses, on LIFO. However, it also points up the fact that even given a simplified LIFO, close to 20% would stay on FIFO for other reasons; thus, a need to conform the lower-of-cost-or-market valuation method to actual business practices.

The public policy implications based on these data are also quite obvious: Without LIFO simplification and a more reasonable and equitable method to value excess inventory, consumers will not have readily available spare parts for their major home appliances, heating and air-conditioning units, etc., and will pay significantly higher prices for those that are available. For industrial customers the same situation would exist for their on-line machines and equipment that produce the goods for defense and consumer consumption.

For business, the ramifications are further compounded. The most serious scenario would be that manufacturers would produce less, wholesaler-distributors would retain and distribute less, retailers would have less to sell, profits would be down, unemployment up, and the entire business sector would again be plunged into a recession.

Mr. Chairman, in order to illustrate the significant economic impact this ruling has on the average wholesaler-distributor, I'd like to quote from a couple of our members who have written us about the problem.

A heating and cooling wholesaler-distributor from Zion, Illinois:

"Late in our fiscal year, when it became evident that we would have no option other than LIFO or write-ups, we began throwing away old parts and inventory. Last year we threw away almost \$5000.00 worth of old inventory, and over the course of the last eight months have been systematically destroying obsolete and old controls which have a limited usefulness. Generally dealers will not buy them at a reduced price unless they need them right then.

"They too have to pay accelerated taxes under the *Thor* decision and cannot afford to stock these items. It is cheaper to destroy obsolete or esoteric items than to save them on the off chance of a future sale. Our business sells furnace and air-conditioning controls. In the future, someone's 10-year-old furnace, which could have been repaired with a part the government 'made' us throw away, will have to be replaced. This wastefulness will certainly encourage obsolescence and contribute to higher prices.

"Under the old system, when written off parts were sold, the government got the benefit of the taxes, and the homeowner got the benefit of the part. Because of the *Thor* decision, the homeowner will not get the benefit of the part, might possibly have to replace an entire unit rather than just one part, and will pay a higher price for the unit to cover the cost of items thrown away. The government still gets the taxes.

"Another factor, which was not discussed in the questionnaire, is the *Thor* penalty for experimentation. In the past, when we have experimented with a new line, we have been able to write off items which were slow in gaining momentum. If a new line failed, write-offs cushioned the loss until the items were finally sold. Several years ago, we began carrying a line of solar collectors. We knew they would be slow movers, but wanting to encourage conservation, we decided to take the risk. Because of the *Thor* decision, we have had to write up our three-year-old inventory of \$500-each solar collectors. We don't want to throw them away, but the tax price for keeping them is too steep. America has been able to grow because change, experimentation, and risk-taking have been rewarded. The *Thor* decision has changed all that.

"If there is anything else I can do to help make our legislators aware of a need for a change in the law, please advise me. Because of this decision, we incurred almost \$30,000 of accelerated taxes last year and will have to throw away thousands of dollars of inventory in the future because it is cheaper to throw it away than to pay the taxes. It is worth my time and energy to help change this situation."

The risk-taking and innovation which characterize the entrepreneurial spirit of the free enterprise system has been seriously affected.

An electronics wholesaler-distributor from Richmond, Virginia:

"Enclosed is the survey form concerning the impact the *Thor* decision and Revenue Ruling will have on our company. Inasmuch as the cost of eliminating any obsolescence factor from our inventory would cause our company to pay approximately \$100,000 in additional taxes over the next ten years, we have undertaken a very vigorous program to determine—as far as possible—parts, and in some cases, entire product lines which move too slowly for us to be able to carry them. Individual parts are being offered at reduced prices and will thereafter be scrapped. We will also discontinue handling a number of manufacturers' lines as a result of this decision. The overall effect will be lower availability of electronic parts for the consumer; this, in turn, will result in higher costs as consumers find they must replace equipment which otherwise could have been repaired."

LEGISLATIVE REMEDY FOR WRITEDOWN PROBLEM

Currently, before the Ways and Means Committee there is a bill that deals with the write-down issue—H.R. 3464. I might point out that there are several other House bills that deal with this issue—H.R. 1523 (Frank) and H.R. 3004 (Jenkins). Also, there are Senate bills S. 1105 (Moynihan) and S. 1570 (Mitchell/Durenberger) which address the write-down issue adequately from our standpoint. I will restrict my comments here to H.R. 3464 since, in its totality, it is the primary bill of concern to NAW.

Section 9 of H.R. 3464 would allow the write-down of excess or obsolete inventory according to a five-year objective standard as follows: 20% for inventory held in excess of 12 months but not longer than 24; 25% of the remaining value of inventory held in excess of 24 months but not longer than 36 months; 33⅓% for inven-

tory held longer than 36 months but not in excess of 48 months; 50% of remaining value for inventory held longer than 48 months but less than 60 months and the remaining value for inventory held longer than 60 months.

NAW strongly supports this five-year objective write-down approach for two reasons.

1. It parallels the simplified accelerated depreciation schedule for machinery and equipment enacted into law in 1981 as part of the Economic Recovery Tax Act; and,
2. It provides a simple audit-proof standard which both IRS and the wholesaler-distributor can easily understand and verify.

LIFO INVENTORY ISSUES

While the write-down of inventory is vital to wholesaler-distributors on FIFO, the need is great to simplify and reform the LIFO method of inventory for those currently using it or for those who wish to use it, but can't because of its complexity and cost (mostly small businesses). It is with that in mind that NAW urges Congressional action on the following inventory reform and simplification items:

Tax on LIFO reserves

The Oil Windfall Profits Tax Act of 1980 contains a provision, offered on the Senate floor at the request of Treasury, that taxes a LIFO reserve upon liquidation of a corporation under Section 337 of the Code. There was no debate on this controversial provision, nor was there any indication that it would apply to any corporation other than an oil company.

Therefore, there was no consideration of its effect on small business.

Section 403(b) of the Oil Windfall Profits Tax Act requires those on LIFO to treat the LIFO reserve as ordinary income upon liquidation.

A common method by which a business is transferred is through the sale of business assets. The assets are sold, and to avoid double taxation (gain to the corporation on sale of assets and gain to the shareholder upon liquidation), the corporation is liquidated under Section 337 of the Code. The proceeds of the sale are distributed to the stockholder or stockholders.

The Service, having previously been requested to review this fact situation, held that "the 'tax benefit rule' does not apply to the bulk sale of LIFO inventory pursuant to a plan of liquidation under Section 337 of the Code." (Revenue Ruling 74-431 C.B. 74-36, 9).

"The 'tax benefit rule' provides that the recovery of an amount that was deducted from income in a prior year must be treated as income in the year recovered to the extent the deduction resulted in tax saving." (Ibid.)

LIFO, the ruling held, does not create a deduction that can be recovered.

Nothing has changed as far as LIFO is concerned since the issuance of the Ruling, except that more and more businesses are looking to LIFO as a means to more accurately reflect cost of goods sold for tax purposes. The Treasury's response is to tax proceeds not heretofore taxable and deemed not to have conferred a tax benefit to the taxpayer because the taxpayer elected LIFO. It almost smacks of retribution.

This was Treasury's provision; unfortunately, Congress, in its desire to pass an Oil Windfall Profits Tax Act, did not give sufficient consideration to the adverse effect of this provision on small business.

The effective date of the controversial provision was delayed two years until January 1, 1982, in order to give Congress an opportunity to review its effect. However, to date, Congress has failed to review this provision via the hearing process and it went into effect without benefit of congressional scrutiny.

On the basis of equity and fairness, NAW strongly urges repeal of the provision or, at a minimum, the solution posed by Section 7 of H.R. 3464 which is to only recapture upon liquidation the difference between the CPI/PPI and the price of the inventory using the LIFO method of valuation. This would eliminate the taxation of inflation generated costs, and tax only the real appreciated value of the inventory.

The recapture provision places a roadblock in the ability of a family-owned, closely-held business to dispose of itself even through the merger or acquisition route. Further, it can significantly reduce the value of the business for sale purposes, thus placing a severe financial hardship on the owner and other stockholders.

In this regard, I would commend to you the extensive legal memorandum prepared by Lawrence F. O'Brien, III of the law firm Dewey, Ballantine, Bushby, Palmer and Wood entitled "LIFO Inventory Recapture—No Mere Technical Amendment." It is the most extensive and authoritative review of the issue I've read.

LIFO simplification

While some measure of LIFO simplification was enacted as part of the Economic Recovery Tax Act of 1981, more is needed.

NAW would urge the following simplification measures contained in H.R. 3464 be enacted:

Increase the one pool test to \$10 or \$15 million in annual gross sales from the current \$2 million. While H.R. 3464 increases the one pool threshold to \$8 million, we believe for the provision to be useful in a practical sense, a higher test is needed.

Allow 100% indexing to the PPI/CPI for valuation purposes. Currently, business with more than \$3 million in gross annual sales can only use 80% of the published indexes.

Allow use of the simpler link-chain method of valuation where internal indexes are used.

Limit number of pools to the 15 major PPI categories (11 for the CPI) with further detailing left to the taxpayer.

Increase to 10 (from the current 3) the number of years a taxpayer has to bring back into income write-downs under FIFO when switching to LIFO.

There are currently two measures in the Senate that would accomplish these objectives: S. 1570 (Mitchell/Durenburger) and S. 1840 (Bentsen).

CONCLUSION

The impact of the proposals set forth in this statement not only makes the LIFO choice more acceptable, but has an equally important effect on capital retention.

During an inflationary period or when interest rates are high, LIFO results in the cost of goods sold being more accurately reflected, thus proportionately reducing income tax liability. This leads to internally generated capital that can be used to finance operations and growth rather than borrowing short term money at exorbitant interest rates.

Given today's economy and the projections for the foreseeable future, LIFO can help realize the desired goals of both business and the Congress, provided business is not denied access to it by complexities mandated by Treasury and not inherent in the theory of LIFO inventory accounting. Moreover, for those who choose to remain on FIFO, an objective write-down standard which reflects reasonable business practices rather than theoretical groundings should be available.

H.R. 3464 and its companion bill in the Senate, S. 1570, will transform the current inequitable and arcane inventory valuation tax laws into a modern, simplified and equitable system that recognizes the current business investment and operating needs of inventory intensive businesses such as wholesaler-distributors.

In this regard, I would like to point out that in April 1983, the SBA National Advisory Council unanimously adopted a resolution that calls for the "simplification and reform of the LIFO and FIFO inventory valuation tax laws, including repeal of the LIFO reserve recapture law." A strong signal that small, growing firms need this to remain competitive.

Mr. Chairman, I would be remiss if I did not address the 1981 revenue estimates for H.R. 2319 which have been attached to H.R. 3464.

First, in our judgement, the application of 1981 estimates to a late 1983 bill is highly misleading. The economic conditions have dramatically changed and the economic assumptions related to such estimates must necessarily be revised in order to accurately reflect those changed conditions.

Second, while the bill may have some short term revenue loss, in the long run, the economic benefits of the bill will result in increased revenues to the Treasury as corporations become more competitive, efficient, and consequently more profitable. Even now, the effective tax rate for the wholesale distribution industry is approximately 36%! Our industry pays a lot of tax both federal and state, therefore, it is difficult for us to understand how H.R. 3464 would cause substantial loss to the Treasury.

Finally, Mr. Chairman, I would like to request that you, as Chair of this subcommittee, request in a formal communication to Assistant Treasury Secretary for Tax Policy Chapoton, the status of the inventory study the Treasury Department was required to have completed by December 31, 1982, under the provision of the 1981 Economic Recovery Tax Act.

It has been almost a year since the due date and to my knowledge the mandated study has not been submitted to Congress.

While I understand the burden under which the Treasury Department technical staff has been laboring, it does not excuse their lack of attention to this study. It

would appear that a Congressional inquiry will be necessary to move Treasury to respond.

Mr. Chairman, I also would be remiss if I did not personally thank you, your subcommittee and the staff for the years of hard work and dedication you have shown in advocating legislation such as H.R. 3464. It is not a politically attractive issue and, therefore, it is difficult to get your colleagues interested in it.

However, the wholesale distribution industry and other small business groups believe it is vital to their survival and we appreciate and recognize your efforts and will continue, for as long as it takes, to seek enactment of this critical legislation.

Thank you.

TESTIMONY OF JAMES M. GOLDBERG, GENERAL COUNSEL, NATIONAL ASSOCIATION OF MUSIC MERCHANTS, NATIONAL ASSOCIATION OF RETAIL DEALERS OF AMERICA, NATIONAL LUMBER AND BUILDING MATERIAL DEALERS ASSOCIATION, AND THE NATIONAL SHOE RETAILERS ASSOCIATION

Mr. GOLDBERG. To underscore some of Mr. Fitch's comments, while the inventory accounting issue is not a politically sexy topic, I can assure you from the standpoint of small retailers that it is an issue of vital concern. There is a lot of talk and attention being given in the U.S. Congress to capital formation and regrettably most of that is focused on the investment tax credit and other means of assuring capital formation for capital intensive industries.

The retail and wholesale industries of this country can't take advantage of the benefits of the investment tax credit. For the most part they are leasers of property instead of owners, and they just don't have the kinds of plant and equipment that the manufacturing sector has and can apply the investment tax credit to.

I liken LIFO and changes in the inventory accounting rules to the investment tax credit for manufacturers. Retailers and wholesalers need modification, continued modification of inventory accounting rules to make LIFO more readily available.

The provisions of the recent tax act which led to the index borrowing rules of IRS were most helpful. Unfortunately, as Mr. Fitch points out, the \$2 million cutoff figure, which I am sure is a somewhat arbitrary number, doesn't help large numbers of legitimately small retailers and wholesalers. There are many businesses in this country that are doing \$5 to \$10 million in sales who are legitimately small businesses competing against large retail and wholesale companies, and while I think that your bill makes a step in the right direction in increasing the \$2 million figure to \$8 million, I think some study needs to be given as to what an appropriate cutoff figure should be. Whether it is taking IRS statistics and trying to figure out what the percentage of businesses fall under what sales figure, I am not sure, but I think what we need is some study and analysis of how many businesses could take advantage of LIFO if the figure were raised to \$8 million, or \$9 million, or \$10 million, or whatever the number is.

Second of all, again to underscore what Mr. Fitch said, I am afraid that it is getting critical that the Congress indicate to the Treasury Department the necessity of coming up with that LIFO subject. The problem we are facing in the Ways and Means Committee, as I am sure you know, is that very few members of that committee can generate a great deal of interest in a subject when

it is "under study by the Treasury Department," and I think what we need from the Treasury ideally is the study itself, but more realistically some kind of a timetable from the Treasury as to when the study is going to get off the ground and when they are going to be in a position to present to the Congress the study which they were supposed to have presented last December.

I would like to underscore Mr. Fitch's request that this subcommittee send a formal communication to Treasury asking them in a very nice, but yet very firm way to come up with a timetable as to when this study is going to be completed.

There are large numbers of retailers and wholesalers out there who would like to be able to take advantage of the LIFO system and who are precluded from doing so because of the current rules, and we appreciate the efforts made by this subcommittee in continuing to focus attention on the inventory accounting program.

As I said at the outset, it is not a very politically sexy topic but it does mean dollars and cents, which is the bottom line for many thousands of small retailers and wholesalers, and for that, we thank you very much.

Mr. NOWAK. Thank you very much.

[Mr. Goldberg's prepared statement follows:]

PREPARED STATEMENT OF JAMES M. GOLDBERG, GENERAL COUNSEL, NATIONAL ASSOCIATION OF MUSIC MERCHANTS, NATIONAL ASSOCIATION OF RETAIL DEALERS OF AMERICA, NATIONAL LUMBER AND BUILDING MATERIAL DEALERS ASSOCIATION, AND THE NATIONAL SHOE RETAILERS ASSOCIATION

Mr. Chairman, members of the Subcommittee, my name is James M. Goldberg. I am an attorney in private practice in the District of Columbia and I spend the great bulk of my time working with trade associations and their members on matters affecting small business. I am appearing here today on behalf of several of our association clients: the National Association of Music Merchants, the National Association of Retail Dealers of America, the National Lumber and Building Material Dealers Association, and the National Shoe Retailers Association.

While the members of each of these organizations operate in differing product areas, they do have several things in common: for the most part, they are small, family-owned businesses operating one or a small handful of stores and with an annual sales volume ranging from just a few hundred thousand dollars per year to between five and eight million dollars. While the latter figure may sound large, I can assure you that these businesses are quite small when compared to the retailing giants which are their competition.

I appreciate the opportunity to appear here today and express the interest of these small business owners in continued reform of federal rules pertaining to inventory accounting so that more capital can be generated enabling these small businesses to prosper and grow. As I know you are aware, Mr. Chairman, the small business community is the backbone of the American economy. And as our economy continues its shift from its manufacturing orientation to one where retailing and service businesses prevail, it is necessary that the Congress, through hearings such as this, keep monitoring the progress of small business so that rules and regulations can be changed where necessary to meet the shifting pattern of the economy.

There are a number of areas where we believe that reform is necessary. Many of these are embodied in legislation (H.R. 3464) introduced by the distinguished Chairman of this Subcommittee. It is gratifying to note that co-sponsors on this bill include the Chairman of the House Committee on Small Business. We are hopeful that this hearing will demonstrate the interest of small business in many of the reforms contained in this bill and that interest will, in turn, spur the House Committee on Ways & Means to give this bill and others like it quick and favorable consideration.

Before touching on many of the provisions in H.R. 3464 which we believe would be helpful to small business, Mr. Chairman, I should note that many of us are anxiously awaiting the Treasury Department study on inventory accounting which was mandated by the Congress. That study, as you know, was scheduled to be completed

last December. It still has not been submitted to the Congress, and we would hope that you and your colleagues would urge the Treasury Department to make this a high-priority item.

Now, let me comment on some of the key provisions in H.R. 3464:

First is the provision which would repeal the requirement for so-called conformity, that is, that the inventory accounting system used for tax purposes also be used for accounting purposes. While conformity is a laudatory aim, the practical reality is that many small businesses which choose to use the LIFO method of inventory accounting often find themselves confronting lenders who don't understand the concept and who view the financial statements which they view for lending purposes with some degree of concern. Even the usual foot-noting of the financial statements to indicate the use of the LIFO system often requires a lengthy explanation of what LIFO is and its effect on a businesses' financial statement. While many bankers are "coming around," the educational process is a slow one, particularly in small communities, and there really appears to be no need for the continued conformity requirement, especially as it pertains to small business.

A second major area of needed reform concerns the index "borrowing" provisions which were added to the Internal Revenue Code just a few years ago. While we in the small business community view these rules as a long-overdue move toward equity—that is, placing small businesses on the same footing as their larger counterparts in the use of the LIFO system—we are concerned that the rules issued by the IRS are still so restrictive as to effectively keep many eligible small businesses away from the LIFO system.

Specifically, we would urge expansion of the dollar sales limitation on small business eligible to "borrow" from government-published price indexes, a simplification in the pooling requirements applicable to indexes which are "borrowed" from, and a simplification of which indexes may be used and under what circumstances.

A third major area of needed reform particularly for those businesses which are unable to utilize the LIFO system, is the permissible use of the cash method of accounting. Congress has recognized the desirability of permitting cash expenditures to be utilized for accounting purposes in adopting changes to the investment tax credit provisions of the IRS Code to permit certain small businesses to expense up to \$5,000 worth of capital expenditures annually as in alternative to using the investment tax credit and applicable depreciation schedules.

Expansion of the cash method of accounting would certainly simplify life for a vast number of small businesses without adversely affecting tax revenue.

Finally, Mr. Chairman, we urge Congress to repeal the LIFO recapture provisions which were so unfairly added to the law in the Oil Windfall Profits Tax Act. As you well know, this recapture provision was added without the benefit of public hearings and we believe that its adoption without proper deliberation and consideration has been responsible for a decision by many small businesses not to convert to LIFO for fear of making their businesses less valuable in the event they were to be sold. We believe this is grossly unfair to small business and should be examined.

Mr. Chairman, you and the members of this subcommittee are to be commended for your continued and deep interest in the problems of small business as they pertain to inventory accounting and capital formation. I have tried in my testimony today to highlight many of the areas where we believe that change is necessary. We hope you will continue your interest in this most important subject and will urge your colleagues on the Ways and Means Committee to promptly hold hearings on H.R. 3464.

Mr. NOWAK. Let me make a general comment. When we looked at this a couple of years ago, and looked at the 1981 act and the new incentives in there for capital business, I think we were talking about the reindustrialization of America. It is ironic, while that quote "term" seemed to be very acceptable by almost everybody, including the large labor force I wonder if that wasn't a misnomer in terms of what in reality was happening to the general economy in this country.

We know in retrospect now that there hasn't been an awful lot of reindustrialization. There has been in fact just the opposite, a condensing of manufacturing, especially by the large heavy industrial corporations that are out there. Yet you know that incentive accelerated depreciation, as you mentioned, the additional tax credit,

really has not had any terrific impacts. The numbers of corporations that have reduced their output, in fact, when you look at steel and auto, have really condensed their manufacturing operations to a large degree.

Somehow I think very individually the trend in the economy, the service sector which includes, I think the two groups that you are representing, along with the whole informational processing area, have not created the vast numbers of new employment we anticipated and yet we almost totally eliminated any substantial tax reform for your sections.

I think you have made some good points out of this meeting. At the very least, we will formally go back and try to get a new estimate of revenue impact of all of these based upon the changing circumstances we have seen occur in the economy.

Second, I think both of your suggestions about the status of the law are very important because I think a lot of people just point to that as an excuse for a substantial re-reading of the tax law in looking very seriously at the changes and impacts that these changes could bring about.

I really think that this section is going to continue to be the growth section in the economy and we have a terrific opportunity to institute some of these inventory reforms. Because I think that this is where it naturally will come about. We look at the kind of unemployment we have in the country and I think it is time we did focus in this whole area.

So we are going to get to Treasury and certainly some of your comments will be incorporated in that formal request as well as some parts of your formal testimony.

Mr. FITCH. If I may make a comment in that regard. I think it would be very timely, because the Congress is in the process right now of evaluating in a very serious sense the fundamental restructuring of the Tax Code with a flat rate tax and the Bradley-Gephardt and Al Ullman's nemesis, the value-added tax and some of those.

I think as part of that debate, that that study by Treasury and the comments that we have made and others, would be valuable. If you are going to undergo a restructuring of the Tax Code then this area of the Tax Code should be considered and recommendations made with regard to that.

I also would like to point out, just for your information, on page 2 or 3 of my statement briefly, the fact that our industry does employ currently about 5 million people, the average workweek of about 38.3 hours, and an average hourly wage of \$6.75. Productivitywise since 1947, we have grown as an industry at an average of 2.8 percent. Measured by output per employee—and this is going to increase due to computerization, education and training incentives and diversification—I think that right now we have a 7-percent wholesaling share of the GNP and it is growing at an annual rate of about 5 percent.

So I think that you are correct in stating that this sector of the economy, coupled with the other service oriented areas, is a very growing area.

Mr. NOWAK. Potentially.

Mr. FITCH. It will in fact be one of the leading edges of our competing domestically and internationally.

Mr. NOWAK. Well, we will try to put this together as soon as we can and I think you are right when you said there are going to be some big structural changes. The "supply-side reductions" which were made, have a generally good effect. When you look at the whole picture, you have got to create a deficit somewhere between 185, and I see the latest figures may indicate 200. So that restructuring will probably lead the administration to see that as a larger problem and I don't think a 1-year deficit impact is going to be that critical when you look at the total economy.

Certainly the accumulation for the next 4 years of those types of deficits has somewhere along the line to have a substantial impact upon the competition for money between the private sector and, of course, the rise in interest rates is thought to be a consequence.

So as we go through that whole restructuring, substantial revenues in this country and we talk about income taxes and so-called reductions which were made in the indexing, all that is going to come under some scrutiny once again in the whole review of taxes.

There has been some indication from the administration that they are going to be looking at other sources and perhaps if you are talking in terms of eliminating the deficit, they are going to be looking at such things as massive sales taxes and probably excise taxes on oil, as well as gas, to try to make up the revenue loss, if you don't use the income tax generation of revenue.

Along with that, they are going to have terrific implications, especially for this sector of the economy. If you are going to impose those, you are going to have to have some counterbalance, if you don't do anything on this side, I think you are going to unbalance even more not only the sector's profitability but competitiveness. So I think you are right when you say this is an appropriate time to get something done, especially when you try to match this up with what may be in the offing to reduce that deficit.

We want to thank you very much for your testimony and certainly we will use your testimony to both get revenue impacts again and the status report of Treasury, we will forward that to you for your review so that you may have a period of comment on it.

Again, thank you very much for your renewed attention to this subject and we will keep moving ahead with as much force as we can.

Thank you very much.

Mr. FITCH. Thank you.

Mr. GOLDBERG. Thank you.

Mr. NOWAK. We will adjourn the meeting.

[Whereupon, at 12:30 p.m., the subcommittee adjourned, to reconvene subject to the call of the Chair.]